COMMERCIAL BANKING LEGISLATION AND CONTROL

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AUTHORS' PREFACE

It is not unfair to say that an undue proportion of English and American banking literature since the War has been devoted to the subject of central banking. Important as has been the extension of central banking functions, both in theory and in practice, in these years, yet the changes which have been introduced into commercial banking by statutory regulation are probably of even more fundamental significance. The following pages will, it is hoped, make it evident that no apology is needed for a treatment of the technical details and of the broad economic effects of such regulation, which is now an almost universal feature of banking activity in every part of the world.

It is not easy to define commercial banking, as its character and scope vary so widely. For the purpose of this book, however, a commercial bank may be described as an institution which accepts from the public deposits repayable on demand. It will be seen that such a definition excludes a large number of important financial institutions which are commonly referred to as banks. There is in most countries a central bank which, although it may still have a few private accounts, does not generally accept deposits from the public. Savings banks, too, are excluded by the definition, as their deposits are not, except in very limited amounts, repayable on demand. Agricultural and land credit banks, mortgage banks and trust companies, as they usually raise their funds by the issue of long-term debentures or fixed deposits, are similarly excluded. As each country is dealt with in the following pages, it will be found that each banking law contains, if not a legal definition of commercial banking, at least a

general description of the institutions to which it applies, or a list of recognised commercial banking operations.

It has not been found possible to consider the commercial banking laws of all countries. Such a course would have been tedious and unnecessary, for it would have compelled much repetition. The aim has been, therefore, to treat only of countries whose laws can be said to make an important contribution to the subject of legal regulation or whose financial importance makes their inclusion desirable.

France and Holland find no mention in the following pages, as they have no specific banking law. It should, however, be added that during 1937 a banking commission has been sitting in Holland to consider whether any statutory regulation is necessary, while a bill to introduce an elementary form of regulation was put forward by the French Government in the early summer of 1937 and may eventually be adopted. Norway, Sweden and Denmark were the first foreign countries to introduce complete banking codes, and an examination of their laws gives some insight into the gradual development of the idea of control. Belgium and Switzerland, on the other hand, are countries in which banking was until recently unregulated, and their laws furnish good instances of modern tendencies. Germany and Italy provide examples of complex banking systems subjected to an elaborate system of control, the structure of which reflects the economic and political creeds of authoritarian states, as well as the peculiar problems of the banks themselves. The Argentine, which is representative both of the pastoral and agricultural states and of the South American republics, shows how the banking problems of a young and expanding country are being met. Czechoslovakia has introduced a banking code only recently, but has developed an elaborate controlling organisation on distinctive lines. Canada is included because it is the only part of the British Empire in which a detailed banking code exists, while Japan merits consideration as the most im-

portant financial power in the Far East. No reason need be given for the inclusion of the United States. Lastly, it has been thought fit to write a few pages on the position in Great Britain, because it was here that the experiment of a national banking code was first made, and because the principles which have guided British bankers for a century or more have frequently been the model for foreign legislation. The only country of importance which has been omitted, apart from France and Holland, is the U.S.S.R., for its banking system is hardly comparable with those of capitalist countries. The savings banks alone accept deposits from the public, and the commercial banks are little more than book-keeping agencies, the function of which is to record the distribution of state credit among the various state-owned industries.

The procedure has been to make each chapter self-contained and to treat each country individually. In some cases no historical introduction has been thought necessary; in others it has seemed that without this neither the significance of the law nor the problems which bankers have had to face could be made plain.

There exist to-day in a large number of countries extremely detailed exchange and clearing restrictions, limitations on dealings in gold and so on. These are not a part of commercial banking regulation proper, and no attempt has been made to review them.

It is safe to say that in no country is legal control the only control to which commercial banks are subjected. There is always some measure of credit control at the hands of the central bank, which, although sometimes based on law, depends frequently on convention, or on nothing more than the accidental structure of the banking system, or the sheer prestige of the central bank. Examples of the last three bases of control may be given from English banking. Firstly, there are the conventions that the different market rates of interest should be linked together round bank rate, and that the clearing banks should not rediscount with the central bank. Secondly,

as a result of the structure of the banking system, open-market operations have a direct and immediate effect on the cash reserves of banks. Lastly, there are occasions on which the Bank of England gives it to be understood that it does not favour a given type of transaction or policy. This is an example of the weight of the Bank's unimplemented authority. Control in these ways is far more highly developed in this country than in others, but it exists elsewhere, and reference will be made to it as the different countries are dealt with individually, as well as to any statutory powers which central banks have over the commercial banks.

No attempt is made in these pages to carry out a thorough comparative study of commercial bank laws. This is partly due to the exigencies of space and partly because very often the value of a given enactment can only be fully appreciated in its context. The writers had to choose between a general treatise on the subject, with reference to banking laws the texts of which could not conveniently be included, and a series of individual essays on the different countries. In the first chapter, however, a short comparative account is given of some of the major features of banking laws in general, with a view to putting side by side the different ways in which the same fundamental problem has been treated in different countries. Although each of the writers is responsible only for the chapters which appear under his name, the book is by no means a collection of isolated essays and it represents the fruits of constant collaboration and discussion. Three of the authors are actively engaged in banking and it is hoped that practical as well as theoretical considerations have been given their due weight.

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Monetary legislation

MONETARY legislation can be said to have passed through three phases. The earliest phase was that of the regulation of coinage, represented in England, since the Norman Conquest, by numerous acts and proclamations fixing the weight of coins and regulating their export. The activities of clippers and counterfeiters, and the needs of kings for funds for the prosecution of wars, resulted in a succession of coinage acts revising the weight and metal content of the currency, usually in a downward direction. The second phase was concerned with the regulation of note issues, which marked the end of the unchallenged supremacy of coin as a medium of exchange. Just as the earlier recoinage acts had been associated with the needs of kings, so the second phase, from the seventeenth century onwards, saw the foundation of institutions such as the Bank of Amsterdam and the Bank of England, to provide for the needs of governments and to create a convenient form of currency for the financing of a growing commercial intercourse. The eighteenth and nineteenth centuries witnessed the growth of the note issues of private banks and a corresponding increase in the laws for their regulation. In most cases the best method of regulating note issues was ultimately found to be the vesting of the sole right of issue in a central banking institution.

As the coin was replaced by the bank note, so the bank note was superseded in turn by the bank deposit as a store of value and the predominant means of payment. In England the third stage, represented by the regulation of

commercial banks, began quite early in the nineteenth century with the creation of joint stock banks without rights of note issue. In most countries, however, the transition has come at a later date.

The growth of control

It is not proposed to follow here the history of commercial banking legislation,—a field far too extensive to bring within the scope of this work,—but the general line of development may perhaps be indicated briefly. The earliest complete banking code was that incorporated in the English Joint Stock Bank Act, 1844, which included many of the provisions which the following pages will make familiar to the reader:—provisions for the control of the number of banks, the publication of balance sheets, audit, minimum capital, returns, restrictions on loans on a bank's own shares, and so on. This act, however, never applied to any but a few banks, and from 1857 onwards banking law was liberalised and became merged in the ordinary company law.

Development in Sweden was in some ways parallel to that in England. After preliminary legislation in 1824, there was published in 1846 a royal decree which may be said to have embodied the principal requirements of a reasonably complete banking code:—provisions for the control of the charters of new banks, for a minimum capital, for the deposit by shareholders of specified security for unpaid capital, for the prohibition of trading in commodities, for quarterly returns, for inspection, for the forfeit of charters in the event of breaches of the law, and so on. Further laws followed in 1855, 1864 and 1873. In 1877 came the appointment of an Inspector of Banks, attached to the Ministry of Finance. In 1903 still further revisions took place. Thus while the specific control of banks declined in England in the second half of the century, in Sweden it gained in scope and in importance. It is perhaps worth noting that England's banking code had come and gone before any specific banking legislation,

apart from these Swedish laws, had been introduced on a national scale elsewhere.

. The English and Swedish codes were followed, though only after an interval of twenty years, by the banking laws of the United States (1863) and Canada (1871). The National Bank Act and the Canadian Bank Act were based largely upon an English conception of the sphere and functions of commercial banking, and were concerned with much the same matters as the Joint Stock Bank Act of 1844, or had their counterparts in existing English practice. Certain differences, however, were noticeable. The appointment in the United States of an independent authority for the control of banking—the Comptroller of the Currency—was an innovation. Among other matters a bond-secured currency, directors' residential qualifications, fixed cash reserves, limitations on real estate ownership and loans, and the restriction on branch banking, were peculiarly American.

The form of the Canadian law was naturally much affected by the National Bank Act of the United States, though showing independence in that it fixed no statutory cash reserves, was designed to encourage branch banking and placed the responsibility for control on the Ministry of Finance. It is to be noticed that in both America and Canada the banks were specially authorised to issue notes, a right which English joint stock banks had virtually long surrendered. The American banking code was not long in being copied elsewhere. "National bank regulations" issued in Japan in 1872 were modelled on it, though they introduced far less control than the American National Bank Act.

Outside the above-mentioned countries there was but little controlling legislation during the nineteenth century. Bank laws existed and imposed elementary requirements, —the registration of new banks and returns to some authority, such as the Ministry of Finance, but nowhere was there anything as elaborate as the codes of Sweden, the United States and Canada. Further revisions of the

banking laws of Sweden and the United States came in 1911 and 1913; important modifications, based on experience during the crisis and slump of 1907, were introduced. There was, however, no other extension of banking legislation before the War, apart from the decennial revision of the Canadian Bank Act in 1913.

In banking legislation, as in other fields, the war years 1914 to 1918 hastened development and in a number of countries such as Norway, where inflation had led to what was regarded as an unhealthy growth of banking institutions, legislation was introduced empowering a government department, usually the Ministry of Finance, to control the formation of new banks and the amalgamation of existing banks. The increasing complexity of such questions made it inconvenient, as time progressed, to have them handled by a government department and the Swedish Bank Inspectorate[1] became a model which was adopted by most other countries as, one by one, they introduced a systematic control of banking operations.

Difficulties arising out of the post-War boom and the subsequent depression are reflected in the introduction of banking codes in Denmark in 1924 and in Norway in 1925, which followed in the main the lines of the earlier Swedish legislation. There was also banking legislation in Czechoslovakia in 1924 and in Japan in 1927.

So intense was the strain on commercial banks during the period 1930-33 that few systems were able to withstand it without serious breakdowns. The banks of the British Empire emerged with a fine record, but there have been extremely few countries outside the Empire in which commercial banks have not had to face either failure, or veiled failure in the form of reorganisation with government aid. General economic events have made the difficulties of the banks more acute, but in most instances the banks themselves have been in some measure to blame. The inevitable, and one cannot but admit appropriate,

[1] The earlier American Comptroller of the Currency is probably the model on which the Swedish Inspectorate itself was established.

result of these occurrences is a great mass of legislation, often extremely detailed and technical in character, designed to regulate and control the institutions to which the people's money has been entrusted.

Methods of regulation

In the early stages of development, banks—apart from note-issuing banks—were subject only to the legal requirements which applied to all enterprises operating for profit. Whether organised as joint stock companies, partnerships or co-operative associations, banks were naturally, right from the beginning, subject to the laws relating to those particular types of institutions.[1] When later developments indicated the necessity for a special control applicable only to banks the legislator had to choose between three methods.

First, he could insert special provisions in the general acts. This method is naturally suited only to those systems which impose a very limited degree of control, and has been employed for long in Great Britain, where such special regulation of banking as exists is almost entirely confined to a few paragraphs of the Companies Act, 1929.

For a more detailed type of control it has been found convenient to take all rules applying only to banks out of the general commercial law and to collect them together in a special banking law which has to be read in conjunction with the general company law, the provisions of which still apply to banks except in so far as they are inconsistent with the provisions of the banking law. Denmark furnishes an example of this type of legislation in the Bank Act of 1930. The method is not, however, found only in countries such as Denmark where banking is restricted to joint stock companies. It is the most convenient way of regulating banking in such countries as

[1] An exception, curiously enough, is England, where joint stock banks were for some decades governed only by laws specifically relating to them.

Switzerland, which has a wide variety of types of banking organisation, embracing partnerships, joint stock companies, co-operative banks and savings banks.

The third method, and one particularly suited to a system where the legal constitution of banks is uniform, is the enactment of a measure which embraces both regulations peculiar to banks and regulations which are similar to those applying to all enterprises with a similar legal basis. Such is the Swedish Bank Act of 1911, a large part of which is concerned with provisions relating to shareholders' rights and so on, which have almost exact counterparts in ordinary company law.

We are now to undertake a brief comparative study of the main features of commercial banking legislation and to arrive at a few tentative conclusions.

Capital

Any commercial institution requires an adequate capital, and this is especially important in the case of banks, for any capital funds over and above those which are invested in premises or otherwise immobilised constitute a valuable reserve for a concern whose business it is to deal in money. Capital may thus be looked upon by depositors as a form of guarantee fund set aside for their protection by the shareholders. In many cases American state laws (and until recently the national banking law) instituted a further protection in the form of a double liability of shareholders. In South Dakota shareholders are still triply liable. Experience, however, has not shown this to be a particularly valuable form of protection, and double liability has at times made it difficult for banks to acquire additional capital when it was sorely needed, and impossible for shareholders to liquidate their holdings without suffering severe losses. In Canada, also, shareholders are doubly liable. Such liability is gradually being reduced, though experience there has been happier than in the United States.

The attempt to secure an adequate capitalisation has

been made in one or more of four main ways. The first and most obvious way has been to provide for a fixed minimum capital. In Sweden, for example, there is a statutory minimum capital of one million kronor, though certain modifications are possible in special cases. Such an arrangement is practicable in a country where the banks are all much of the same size and importance, but clearly would not be applicable to a country such as the United States, where variations of size are great. The result would be that while depositors of the smaller banks might be safeguarded, there would be no adequate protection for those of the bigger banks. In Belgium there is a minimum capital of ten million francs for new public banking companies and of two millions for new private banks. There are also similar provisions in Norway and Denmark, but the legal minimum is lower, reflecting the different structure of the banking system. There is, however, a tendency to raise statutory requirements in line with economic development. In Canada and Czechoslovakia there are also minimum capital requirements, but in the latter case the requirement applies only to commercial banks which accept savings deposits. In Canada the provision is of little practical importance, for the capital of all banks but one is many times greater than the statutory minimum.

A second method is that adopted in Switzerland, where the capital of a bank is required to amount to a fixed percentage of liabilities,—a percentage ranging between 5 per cent. and 10 per cent. according to the constitution of the bank and the nature of its assets. This seems a more accurate way of securing that a bank shall have sufficient capital, but does not take into account the fact that the wider the scope of a bank's operations, both as regards the area served and the type of industry financed, the smaller should be the required ratio of capital to liabilities. In banking, as in other industries, large-scale operation has its economies, and a big bank with its interests scattered over a wide area does not require as high

a ratio of capital to liabilities as a small local bank. It is worth noting that in Switzerland the legal ratios vary according as the banks' liabilities are or are not invested in specified types of securities of a high class. Deposits not invested in such "gilt-edged" securities require to be strengthened by a wider margin of capital, presumably because in the case of ultimate liquidation securities which are not gilt-edged are more likely to have depreciated. The Argentine law belongs also to this category, but here the ratio is between capital and reserves, and savings deposits.

A third method is that adopted (exclusively) in the United States, where the statutory requirements as to capital depend on the population of the place in which a bank is situated.[1] A further provision of the National Bank Act gives only the larger national banks the right of opening branches outside the city, town or village in which they are situated. Such a system seems to have little to recommend it, for it operates against the strong medium-sized banks opening branches in rural areas. In short, it tends to confirm the unit banking system with all its weaknesses and abuses. Further, the requirement that a bank situated in a city with over 50,000 inhabitants should have a capital of at least $100,000 (the maximum provision) is hardly exacting. A bank in one of the biggest cities with a capital of this size might be severely under-capitalised. An arrangement in some ways comparable with this is found in Italy, where statutory minimum capital varies with the size of the area served by a bank, and in Japan, where banks with offices or branches in the two principal cities require a larger minimum capital than other banks.

The fourth method is that followed in Spain, where the authorities fix a given capital for each bank according to its particular circumstances.

Combinations of different methods are possible.

[1] In the national banking code and in the laws of 42 of the 48 states in 1935.

Under the bank law of the State of California, in addition to capital requirements based on population, every bank must have a paid-up capital and surplus equal to 10 per cent. of its deposits up to $1 million and 5 per cent. of its deposits in excess of this. Here, therefore, the economies of large-scale operation are recognised. In several countries both the first and second methods noted above have been adopted. In Denmark, for example, there is a minimum capital requirement of 300,000 kroner (which not all banks have yet met) as well as a minimum ratio of 10 per cent. between paid-up capital and surplus, and liabilities. In Sweden, too, in addition to a fixed minimum capital for all banks, there is also a legally required ratio between a bank's " own funds " (including capital, reserves and special types of bonds issued by Swedish banks) and deposit liabilities. In Germany a maximum ratio of not more than 20 per cent. between total liabilities less short-term assets, and capital and published reserve (surplus), is required. This ratio may be varied, according to the type of bank involved.

It will be seen, therefore, that a wide measure of variety is possible, though there is complete unanimity that some regulation of capital is necessary in the interests of safety.

Surplus

In many countries a substantial legal minimum capital has not been deemed sufficient, and there are requirements as to surplus or reserve. In England the clearing banks have large hidden reserves as well as their published reserves, and this is probably the practice of the bigger banks abroad. But however this may be, the legal requirements as to a published reserve are in most countries not unexacting. In some cases new banks cannot now start business until they have a certain minimum paid-up surplus, that is, they are virtually compelled to issue their shares at a premium. It is more usual, however, to require that banks shall constitute reserves or surpluses from undistributed profits.

The extent to which surpluses must be built up varies. In the Argentine banks are required to set aside each year at least 10 per cent. of their realised profits, until the surplus amounts to at least 50 per cent. of paid-up capital, and until capital and surplus together equal 33 per cent. of their savings deposits. The relating of capital and surplus to savings deposits appears to result from the importance attached to the protection of small depositors. It will, in addition, be noticed later that in the Argentine savings deposits up to a certain stipulated amount are given preference, in case of ultimate liquidation, over other classes of privileged credits. In Switzerland, where the practice of carrying hidden reserves is probably more widespread, only 5 per cent. of annual net profits need be carried to reserve and a final reserve of only 20 per cent. of capital is required.[1] In Sweden the figures are 15 per cent. of annual profits and 50 per cent. of share capital, in Belgium 5 per cent. and 10 per cent. In Czechoslovakia all banks which accept savings deposits are required to possess a reserve against losses of 15 per cent. of capital. Probably the most stringent regulation of all is that for U.S. national banks. No new national bank may commence business unless it has a paid-up surplus of 20 per cent. of capital. Further, every national bank is required before declaring a dividend to carry forward 10 per cent. of its net profits until surplus equals capital. This is, in some cases, a slow process. The latter part of this provision is found also in the Japanese law. In Canada there is no minimum requirement as to surplus, but no bank may pay a dividend of over 8 per cent. unless surplus equals 30 per cent. of paid-up capital.

It is evident that the constitution of a surplus of substantial proportions is an alternative to the double liability of shareholders, but one that is both less oppressive to shareholders, for it does not impose a sudden strain on them as double liability may do, and safer for depositors,

[1] The obligation to add to surplus is, of course, not peculiar to banks and is found in company legislation in most European countries.

for a paid-up surplus should be a stronger guarantee than the paper liability of a number of small shareholders. How strong a guarantee a paid-up surplus affords in practice depends on the form in which it is maintained. All too often surpluses have been found at times of crisis to be as immobilised as capital and deposits, for very seldom is there any legal specification as to the type of assets in which they should be invested. In Bulgaria, however, a certain proportion of reserves has to be deposited with the National Bank, and in one or two minor instances and one major instance (Belgium) there are requirements that they should be held in the form of government securities. Lastly, in the Argentine there are regulations which limit the extent to which capital and reserves may be invested in certain forms of long-term assets.

It should perhaps again be emphasised that a surplus cannot rightly be looked upon as a cash fund held to meet a run on a bank, but that it should be considered as a reserve which will, in the case of ultimate liquidation, make good to depositors any loss which they may suffer through a depreciation of the assets in which their deposits are invested. Even so, it seems rather illogical to stipulate that a surplus should be built up, but not to require that it should be held in a form of asset which retains some high proportion of its value, even in times of depression.

In conclusion, one may question the principle on which legally required surpluses are established. There is much to be said for the view that, if the law is to require banks to provide themselves with a given capital, that legally required capital should be adequate, and of such dimensions as to make the provision of a reserve unnecessary. To require a bank, on starting business, to have a capital of, say, 1,000,000 francs and a surplus of 200,000 francs is no different from requiring an initial capital of 1,200,000 francs, and there is no logical reason for a distinction. On the other hand, although there are arguments in favour of building up reserves from profits, it is preferable that

such allocations should be true surpluses. It is a short-sighted policy to build up reserves, if this involves paying small dividends over a long period of years and thus injuring the credit of the banks.

Cash reserves and liquidity

The liabilities of commercial banks are to some extent payable on demand, and for this reason the practice has always been followed of keeping a reserve of cash and liquid assets to meet any demands that may be made. In many cases the law requires that there shall be a given percentage of such reserves to liabilities. The avowed purpose of cash reserves is liquidity, and, although, as is explained later, the legal requirements seldom achieve this end, it is from this point of view that they must first be considered. The subject is best introduced by a discussion of some of the variations in detail which exist in the different laws.

The first variations are those found in the definition of cash. Sometimes, as in the case of member banks of the U.S. federal reserve system, " cash " is a balance with a central bank. More normally, as in the Argentine, a given percentage is in the form of coin and notes and the remainder in the form of a balance at the central bank; or it may be held, as desired, in either or both forms, as in Canada. In Germany cash reserves are defined as cash in hand and balances with the Reichsbank and the Postal Cheque Office. In other countries the reserve is held in a more varied and less liquid form. In Sweden, for example, reserves are required to be " readily realisable assets ", which are not defined by law, but in practice include cash in hand, balances with the central bank and other banks, sight drafts and government and similar bonds. In Switzerland the reserve takes the form of " disposable assets ", which are defined as including cash, balances due from the postal cheque service, and clearing accounts at the National Bank. " Easily mobilisable assets " form another category and include the more liquid types of

paper asset, such as bonds, treasury bills and bonds, and commercial bills. Given percentages of deposits must by law be held in the form of both disposable and easily mobilisable assets.

Secondly, the legal reserve ratios themselves vary as between country and country, even where the definition of cash reserves is the same or similar, according to the nature of the liability against which the reserve is constituted. In Sweden, for example, the ratio is 25 per cent., but it must be remembered: (a) that the reserve is only in the form of readily realisable assets; (b) that it is held only against demand deposits, which amount to a mere 18 per cent. of total deposits; and (c) that there are no other liquidity stipulations of any sort. The Swiss system is too detailed to analyse here (but see page 361); in brief, it may be noted that the actual ratio of disposable assets is very low, even though related only to short-term liabilities, because other liquid (i.e. easily mobilisable) assets are required to amount to a high percentage of short-term liabilities. Where the law constitutes a strong second line of reserve, the first line need not be so strong as safety would otherwise demand. Among the most stringent requirements is that of the Argentine, where a reserve ratio of 16 per cent. of sight deposits and 8 per cent. of time deposits must be kept (and, it will be remembered, in the form of cash or a central bank deposit). In Canada the ratio is only 5 per cent., but cash reserves cannot be drawn upon. It has already been noticed that in Switzerland the ratio is, to all intents and purposes, one of short-term (liquid) assets to short-term liabilities. It may be added that as, in individual banks, the proportion of short-term to total liabilities rises, so does the statutory reserve ratio. It is progressive. In other countries, of which the United States is the chief example, a smaller reserve is required against time or savings deposits than against demand deposits. This is found also in the Argentine, and the arrangement is, of course, a very logical one if, as is still widely held, the purpose of the

cash reserve is to safeguard liquidity (not to afford long term protection to savings depositors, who are protected by the provision of an adequate capital and surplus).

Some laws require no cash reserve at all against time or savings deposits. This is the case in Sweden and Switzerland. In Denmark the banks are required to keep a reserve (cash and readily marketable bills and securities) of 15 per cent. against demand liabilities, and in addition a reserve varying between 1 per cent. and 3 per cent. of total liabilities. Even so, the requirement is a moderate one, and the actual reserves of the larger banks are far in excess of these figures. In Germany two reserve ratios are to be enforced, one of cash to short-term liabilities (up to 10 per cent.) and one of secondary reserves in the form of commercial bills and certain securities to total liabilities excluding savings deposits (up to 30 per cent.). The actual percentages (which have not been fixed at the time of writing) will vary in each case according to the bank's constitution and balance-sheet position.

Thirdly, bank laws sometimes fix different ratios for banks of different sizes. In the United States (until all reserve ratios were increased by 50 per cent. in July, 1936[1]) the legal requirements for demand deposits were 13 per cent. for central reserve city banks, 10 per cent. for reserve city banks and 7 per cent. for all other banks. This is a relic of the days when there was no federal reserve system and the bigger banks in the chief cities acted as bankers' banks for those in the smaller cities, while the latter in turn fulfilled this function for country banks. The bigger banks were justifiably required to make special provision for the withdrawal by the smaller banks of their deposited reserves. Though the tendency still exists in the United States, it is rather surprising that it is recognised by law, for one of the purposes of the organisation of the federal reserve banks was to supersede this system, and the

[1] A further increase of 33⅓ per cent. was announced on 30th January, 1937. The reserves are thus now double their original size.

reserves which the act exacts are, after all, in the form of a balance at a reserve bank. It will be noticed that it is assumed that only big banks congregate in the big cities. This is by no means to be taken for granted, and in so far as it is not universal imposes an unfair strain on small banks in the big centres.

The same arrangement prevails in Denmark, though to a less exaggerated extent. Here, too, there is a tendency for small banks to redeposit with the larger banks.

Seldom does legislation recognise the law of large numbers, i.e. that the bigger the bank the smaller is the reserve ratio which it requires to keep. English experience has proved the validity of the law ; and further, it has in every country nearly always been the smaller banks which have first found themselves in difficulties in a crisis.

Fourthly, it is by no means unusual under American state bank laws for cash reserves to be based on the population of the cities in which the banks are situated (e.g. the laws of New York and California). This system of progressive ratios is designed to take account of the practice of redepositing.

It is perhaps worth while here to analyse shortly the concept of liquidity. Four different uses of the word may be distinguished. First, there is the liquidity of a single asset. A seasonal loan to a well-known customer,—for the purchase of raw material, the transport of manufactures or the purchase of seed,—may be designated liquid. Secondly, we may refer to the liquidity of a type of asset. Bills accepted by first-class banks under documentary credits are liquid in this sense. They turn automatically into cash at their maturity dates. Thus the "bills discounted" of the English clearing banks (which include also treasury bills) are a liquid type of asset. Thirdly, an individual bank may be said to be liquid to the extent that its depositors can be paid out without delay. To what extent this can be done depends largely on the size of the bank, the eligibility of its assets for rediscount or purchase by the central bank and the ability

of other banks or their customers to take over assets from it. While a small American unit bank might be very liquid in this respect, an English clearing bank would not. It is to be noted that liquidity is here a synonym for "shiftability". Lastly, there is the liquidity of the banking system as a whole, a concept which has no counterpart in real life.

Of these four concepts it is primarily with the third that banking laws are concerned. It is clear that arrangements made to secure that a bank shall always have sufficient cash to meet normal withdrawals have nothing to do with liquidity; the word implies ability to meet exceptional demands. Similarly, a bank is not liquid merely because it has a central bank balance sufficient for ordinary clearing requirements. On the other hand, few of the banking laws seem to fit commercial banks for exceptional withdrawals, apart from those of them which contain provisions for the relaxation of ratios in case of need. Where no such provisions exist, as, for example, in Canada, the very assets with which a bank could most easily satisfy a demand for cash and which it could most easily realise are probably those which the law requires it to hold in its tills and portfolios. The strength of a member bank of the federal reserve system depends not on its statutory cash reserve, but on its excess reserves or holdings of paper eligible for rediscount, in fact on its liquid assets over and above its legal reserves, or what are sometimes referred to as its secondary reserves. Thus arises the curious situation that the higher the legal reserve ratio the less liquid a bank's position may be, except in the case of an ultimate winding up. In short, statutory cash reserves in practice serve much the same purpose as that proportion of the assets which represents capital and surplus, assuring ultimate protection to depositors, but not short-term liquidity, especially where a whole banking system is involved. This was particularly evident in the United States in 1933. The United States, however, as a result of legislation in 1933 and 1935, is

to-day one of the few countries in which the contradiction of immobilised cash reserves no longer holds. The Board of Governors of the reserve system is now able to vary the legal reserve ratios of its member banks and could thus, at a time of emergency, release cash by reducing reserve ratios (though whether such a policy would be followed is another matter). A provision for the variation of reserves exists also in New Zealand. In Germany [1] the banks are, in certain circumstances, to be temporarily excused from observing the statutory ratios ; the same principle is therefore at work here. In the Argentine law, too, there is a provision for the relaxation of ratios. In short, a statutory reserve ratio does not of itself ensure liquidity. Only in so far as it may be relaxed is it useful in meeting unexpected withdrawals,[2] and even then only withdrawals of moderate dimensions.

Statutory cash reserves are not the only medium through which banking laws endeavour to secure liquidity. In many cases there are qualitative restrictions on the type of asset which may be held with that part of a bank's funds not preserved in the form of cash. These will shortly be considered under another head and it will be seen that they may conduce greatly to a sound and liquid position.

Although statutory cash reserves have only a limited value as a means of ensuring liquidity in periods of crisis, other functions may perhaps be claimed for them. No study of the subject would be complete without reference to the report of the Committee on Bank Reserves of the Federal Reserve System, published in the annual report of the Federal Reserve Board for 1932.[3] Although no action was taken as a result of the report, it is worth summarising briefly. The Committee found the existing system of cash reserves in the United States ineffective

[1] In Germany ratios may be varied, not only for the banking system as a whole, but also for individual banks.

[2] The position is analogous to that of the Bank of England under the Bank Charter Act, 1844.

[3] Pp. 260-85.

because it did not relate the expansion of member bank credit to the needs of trade and industry; inequitable because it did not take into account genuine differences in the character of banking carried on by different banks; and inappropriate because, in the opinion of the Committee, it is no longer the function of statutory reserve requirements to preserve the liquidity of individual member banks, but rather to furnish an instrument of credit control,—the necessity of having to increase reserves as deposits and credit expand being a restraining influence,—and to provide the federal reserve banks with funds. It was felt that some scheme was required which should relate reserve ratios more accurately to the turnover of deposits than did that which established a smaller ratio for time deposits than for demand deposits. Two banks might have equal volumes of demand and time deposits, and yet the turnover in one case be much greater than in the other, owing to a difference in the velocity of circulation of their demand deposits. A bank whose deposits have a high rate of turnover should be required to keep big reserves, just as much as a bank with large deposits or a high proportion of demand deposits to total deposits.

The proposal of the Committee was to abolish the distinction between time and demand deposits and between central reserve city, reserve city and country banks; to require a reserve in all cases of 5 per cent. of total net deposits plus 50 per cent. of the average daily withdrawals of deposits (i.e. debit entries); and to limit all reserves to a total maximum of 15 per cent. of gross deposits, thus recognising the fact that an increase in velocity is as much a feature of bank deposits in times of over-expansion as is a growth in volume.

There seems much to commend this view of the function of cash reserves, i.e. that they are an instrument for quantitative rather than qualitative control. One would have little hesitation in saying that the balance of the conventional reserves of the English clearing banks

over and above their requirements for normal till money and the clearing is far more useful as a basis for Bank of England open-market policy than as a reserve of liquid funds. It is probably becoming increasingly recognised in countries with banking laws that something more than a statutory cash reserve (even though permission is granted in time of crisis to suspend the law) is needed to secure liquidity, and that the problem may best be solved by provisions with regard to the nature and distribution of a bank's other assets.

Restrictions on assets

As suggested in the last paragraph, if any attempt is to be made to secure a bank's liquidity by law, the most effective method is not to fix a maximum cash reserve, but to stipulate what kind of assets it may or may not acquire. Too great a degree of regulation, however, makes for an undesirable inflexibility. It was for this reason that Sir Otto Niemeyer, in his recommendations for a banking law in the Argentine, did not look with favour on too detailed an elaboration of rules as to permitted investments. Curiously enough, the official report on which the Swiss law is based emphasises the disadvantages of hard-and-fast rules, but the law itself contains one[1] which has no parallel, except in Germany. Negative regulations, forbidding certain kinds of asset or transaction, are far more common and also more fruitful of liquidity.

An almost universal restriction is that on the ownership of real estate other than premises. The best banking practice for well over a century, so far as Great Britain is concerned, has recognised that investment in real estate is undesirable. United States national banks have been restricted in this field since 1864. In Sweden banks may not acquire real estate (beyond premises) except as a result of foreclosure, and it must be sold as soon as it is possible to do so without loss. In Denmark real estate or

[1] See pp. 362-3.

shares in real estate companies may not be carried in a bank's books at a value exceeding 20 per cent. of its capital, bank premises again being excluded. This is a comparatively generous allowance in itself, but in addition the Bank Inspectorate may waive the restrictions temporarily, if a bank is compelled to foreclose in order to safeguard a loan. In Italy all proposed purchases of real estate must now be submitted to the Inspectorate, and the Inspectorate may require the gradual disposal of real estate not used as premises. In the Argentine banks may hold property for their own use up to a value of 20 per cent. of capital and 50 per cent. of surplus, but any acquired over and above this or for other purposes must be sold within four years. This represents a strict limitation on the value of premises. Some of the American state laws also limit the value of premises to certain percentages of capital or capital and surplus. In Germany permanent participations and investments in property and buildings may not exceed capital and reserves. On the other hand, the Swiss law has no restrictions of any kind on investments in real estate.

Few would contest the wisdom of restrictions in this field. It may indeed be regretted that in some countries laws do not go far enough, for there are not always restrictions against holding shares in real estate companies, though this practice is often as little conducive to liquidity and security as holding real estate itself.

Similar restrictions on other types of asset will be found in succeeding chapters,—on chattels, commodities and so on. These cannot be examined here, but it may be noted that such activities may be precluded by implication, for sometimes (as in Denmark) a banking law contains a list of recognised operations in which they do not figure.

Restrictions on loans to one customer are also almost universal to-day. These may be extremely complicated, as in the case of the United States national banks, Germany and Denmark, or may consist of a general admonition, as

in Sweden, that special care must be taken that loans to any one customer are not so great that the stability of the bank is endangered. In Switzerland there is no restriction at all. The more usual restriction is a straightforward one limiting such loans to a definite percentage of capital, though there are sometimes exceptions in favour of loans on certain specified types of security. Percentages as high as 35 per cent. of capital are found. The difficulty with provisions of this sort is to prevent the possibility of subterfuge, e.g. through borrowings by a customer's wife or business associates, or through the discount of bills drawn or accepted by him. Any guarantee given on the customer's behalf, or loans to enterprises in which he is financially interested, should also be taken into consideration.

The principle of spreading assets, not only geographically, by industries and by maturity, but also among a large number of borrowers, is also one that has long been followed by English banks. In February, 1936, Barclays Bank Limited published figures showing that their 200,744 loans and advances were so distributed that the average advance only amounted to £774. The dangers of overlending to individual customers arise mainly, of course, in countries where banking concentration has not taken place, and past experience has shown that legal restrictions in this matter are far from being unnecessary.

Security for loans

It has been a common banking experience in recent years to find not only that customers have been unable to repay advances, but also that security pledged as cover has only been realisable at great loss. It has been common, too, to experience losses on unsecured loans. In many countries there are now legal provisions to meet loss in the value of collateral, and to provide for adequate security. It is interesting to note that in Sweden there exists a general statutory principle that unsecured advances

may not be granted, though there are certain important exceptions. Further, a reasonable margin is required between the amount of an advance and the market value of the securities pledged, and depreciation in value must be made good by further pledges, when loans are renewed. In Germany a variable limit, standing at present at Rm. 5000, is set to unsecured credits, unless accompanied by the borrower's statement of affairs or balance sheet. This provision in the law of 1934 was directed against the custom prevailing prior to 1931 of advancing quite large sums, often to industrial undertakings, without security or a previous examination of the customer's position. In Italy the Inspectorate is empowered to require that applicants for credit shall make declarations regarding their capital and economic position. All borrowers of sums over lire 25,000 are, since September, 1936, compelled to file a detailed statement of their assets and liabilities. Detailed legal regulations of this sort should not really be necessary : and they are only found in the two totalitarian states. In the United States the Board of Governors of the reserve system fixes from time to time the percentage of their capital and surplus which member banks in the different reserve districts may advance on stock or bond collateral. The purpose of this, however, is to control the speculative carrying of securities by customers of the banks, rather than to protect shareholders and depositors. Further, any member bank may be ordered to refrain from increasing such loans. In Denmark there is no limitation on loans on securities, except that a bank may not accept its own shares as security to a greater amount than 10 per cent. of its paid-up capital. Some such provision as the latter is common to nearly all laws, though in most cases it is more rigorous. In Canada banks are forbidden to lend on the security of any bank stock ; in the Argentine no bank may lend to any other bank on the security of that other bank's stock. An English bank, on the other hand, is always ready to advance against its own shares, and there

is, in fact, no danger in such a practice to-day, though the Joint Stock Bank Act of 1844 prohibited it. One might argue, indeed, that such loans have no theoretical justification, for they amount to a reduction of capital, but as long as there is a market in a bank's shares and the bank makes a point of immediately reselling any shares which it may have to take over, the risk is no greater than that involved in making loans on other stock-exchange securities of similar standing.

A frequent origin of loss in the United States has been the granting of loans on the security of real estate, which in that country seems particularly subject to variations in value. The National Bank Act, therefore, imposes very wide margins, and, further, no national bank may make real-estate loans in excess of its capital and surplus, or 60 per cent. of its deposits, whichever is the greater. In New York State state banks are not ordinarily permitted to make loans against second mortgages. Here, characteristically enough, the total of real-estate loans may not exceed specific percentages of capital and surplus, fixed according to the population of the community in which a bank is situated. Such restrictions are rare in Europe. Peasant proprietors usually have specialised agricultural credit associations (though these exist, too, in the United States). The restrictions are, however, found in some of the Dominions, and are to be expected in new countries, where land values fluctuate and many borrowers have little to pledge apart from their land. In Canada land may only be taken as additional security, on a loan already contracted. In England land is perhaps the most common and most valued form of security accepted by the banks.

The decline of mixed banking

One of the most striking tendencies of modern commercial banking is the displacement in a number of countries of the formerly prevailing "mixed banking", in favour of a division of functions modelled on English prac-

tice. It is not necessary here to embark on a description of mixed banking as it has existed in Germany, Italy and Belgium, to a smaller extent in Switzerland and also in a different form in the United States, to cite the chief examples. Its nature varied: sometimes it took the form of important "participations", different banks being associated with different industries and represented on the directorates of the leading firms in those industries. Sometimes it implied issuing and holding large blocks of shares and bonds of industrial undertakings. In the United States banks were interested not so much in industry itself as in issuing shares and carrying them until a favourable opportunity occurred of placing them on the market at a profit. Sometimes the interest of the banks in this business was veiled by the formation of "security affiliates" completely owned by the banks themselves. Whatever form it took, this tying-up of funds in assets which could not easily be liquidated constituted in times of emergency a grave prejudice to the interests of current-account depositors. A great part of the banking failures of the last eight years can be attributed to the freezing of assets.

Illiquidity, however, is not the only danger inherent in mixed banking. It might be argued that the risk of loss is as great or greater. In short, the risk involved in permanent or semi-permanent participation in industry is not a proper banking risk, inasmuch as the banker is not a financier but merely one to whom the resources of others have been entrusted for safe keeping.

The most complete separation of functions has taken place in Belgium, a country in which mixed banking had been very widespread since the earliest days. The law of 1934 forbids banks which accept deposits at interest repayable within two years to hold shares in or participate in any commercial, agricultural or industrial enterprise,—with certain minor exceptions. In effect, a fundamental reorganisation and reorientation of Belgian banking has been involved. Sweden is another country in which the

banks played an important part in the long-term financing of industry, usually through the formation of subsidiary finance companies or by way of advances to industrial undertakings on their own shares. Under the 1933 Bank Act Swedish banks are now prohibited from acquiring shares, except to protect an advance, and from lending on securities unless there is a reasonably wide margin between the amount of the advance and the market value of the securities. Swedish banks have never been permitted to deal in securities for their own account, and they are not allowed to accept as security the shares of companies which deal in and issue securities. In Norway the banks have been prohibited since 1924 from acquiring permanent interests in industry, and bank officers are not allowed to act as directors of industrial concerns without permission. Further, no bank may hold shares to a value of more than 20 per cent. of its capital and surplus, or deal in shares for its own account. It is still permissible, however, to purchase new issues, provided that they are placed within three years. In Germany, assets consisting of shares other than permanent participations or of bonds not quoted on the German stock exchange may not exceed a given percentage of liabilities (still to be fixed). Permanent participations and real-estate holdings together may not exceed capital and surplus. In the Argentine, as a result of the law of 1935, no bank may hold for a period longer than two years after their purchase shares or debentures of a business concern to an amount exceeding 20 per cent. of the concern's capital or 10 per cent. of its own capital and 25 per cent. of its surplus. No bank may under any conditions participate directly or indirectly in a commercial, agricultural or industrial enterprise of any description whatsoever. In Switzerland, where mixed banking has never been so developed as in Germany and Belgium, there is no provision similar to those enumerated above. But even here the auditing associations are bound to bring to the notice of banks any "unsafe practices" in which they indulge, and to

report them to the Banking Commission, if not corrected. As the statutory balance sheet has to be accompanied by detailed information as to shares and bonds held, it is safe to assume that attention is given to dangers in this direction. In Italy special institutions have been formed to take over from commercial banks their long-term advances to industry, and to provide permanent capital for industry. The separation of functions has been one of the major principles underlying recent changes in Italian banking. The tendency noticeable in all these countries is remarkable, for in many cases their banks have played an important part in the long-term financing of industry. Whether the chief danger of permanent participation is illiquidity or actual loss is a debatable point, but, whichever is the case, the new direction given to commercial banking on the continent of Europe should make ultimately for a sounder system of banking.

In the United States, which, as stated above, had its own peculiar form of mixed banking, the Banking Act of 1933 prohibits member banks from being affiliated to or controlling any corporation or association engaged principally in the issue, flotation, underwriting, sale or distribution of stocks, bonds, debentures and other securities. Nor may bank officers act as officers or directors of such institutions (a similar provision is found in Swedish law). Further, under this act and that of 1935 member banks may only deal in securities for account of customers, except under such terms as the Comptroller of the Currency may prescribe, and even then not more than 10 per cent. of capital and surplus may be invested in the securities of any one obligor or maker (apart from federal or state bonds). Nor may banks underwrite new issues. The disaffiliation of American securities affiliates is undoubtedly one of the greatest banking reforms of recent years. Experience has shown that the profits of years of operation can easily be dissipated through a few unprofitable holdings in a time of falling security prices. If the affiliates are, as is usual, dependent on the banks for funds,

and these funds are in turn repayable to the banks' customers on demand, calamity cannot but occur in a period of depression and lack of confidence. Other dangers which arise are that a bank tends naturally to lend to customers more willingly on securities sponsored by its affiliates than it would otherwise do,—in order to facilitate their distribution ; or customers of the bank may sustain losses on securities purchased from an affiliate, to the detriment of what the Americans call good " customer relations " ; or the affiliate may suffer big losses which injure the bank's prestige ; or the bank may undertake unduly risky transactions, relying on its power to shift the doubtful asset to the affiliate's balance sheet in case of need. These are but a few of the dangers which may arise, and did arise in the United States in the years prior to 1933.

Such dangers as have been envisaged above are not, however, inherent in mixed banking. In Denmark, for example, the deposit banks have for long issued and marketed the shares and bonds of industrial enterprises, and loans have been made against securities on a large scale, though actual holdings of securities may not normally exceed 50 per cent. of a bank's capital. Further, banks are specifically permitted by law to " co-operate in the establishment of trading undertakings ". Clearly the possibility of such transactions depends on (a) the caution with which they are undertaken, (b) the extent to which deposits are repayable on demand (small in the case of Denmark), (c) the frequency and severity of financial panics and crises, and (d) the grade of security and the length of time for which it is held.

Interest on deposits : interest on loans

Another measure of control found in some countries is worth consideration because it represents a recent departure, i.e. the regulation of interest on deposits. The 1933 act in the United States prohibits the paying of interest on demand deposits (deposits repayable within

30 days). In the Argentine the interest paid on sight deposits must be at least three points less than the central bank's rediscount rate and on savings deposits at least one point less : i.e. with a bank rate of 3 per cent. no interest would be payable on sight deposits. A similar provision in the Swiss law is the requirement that a bank with a balance-sheet total of over twenty million francs must inform the National Bank two weeks in advance of any intention to raise the rates on its short-term debentures (*obligations de caisse*). The National Bank cannot veto such increases, but may attempt to dissuade the bank from effecting them.

These measures are the result of a common experience, —competition in time of stringency to attract liquid resources by raising rates of interest. The danger of such action lies in the fact that the public cannot create deposits and that one bank can only gain at the expense of another ; for it is very unlikely that net saving could be appreciably increased in this way, though it might result in a diminution in hoarding. In countries where banking is highly concentrated the temptation to pursue such a policy is less strong, for it is easier for the banks to reach agreement among themselves. It should be stated, however, that it is not only in times of emergency that banks compete for deposits. Competition was strong in the United States throughout the period 1923–29, and resulted in high interest payments and speculative transactions (to meet the cost of interest) on the part of the banks. It is to be noted that in Canada, contrary to usual practice, banks are specifically authorised to pay any rate of interest on deposits.

It will be seen later that special emphasis is placed on the control of interest on short-term bonds in Switzerland and time deposits in the United States. To bid for new funds of this character has proved highly attractive, for they are not withdrawable on demand and they usually carry smaller cash ratios.

The control of deposit rates should be contrasted with

the control of interest rates in general, of which the main purpose is to regulate the price of credit where a central bank has no actual control or where no conventions as to rates exist. In Italy the commercial banks came to an agreement in 1932 with regard to interest rates on deposits. Under a decree of May, 1936, infringements of this agreement have become a punishable offence. The "cartel agreement", however, is now to be superseded by a scale of rates fixed by the Inspectorate, both for deposits and for discounts and loans. In Germany the maximum debit and credit rates of interest, while ostensibly fixed by the banks themselves, are virtually under the control of the Banking Commissioner. Again, under the Czechoslovakian Banking Law of 1932, the government may compel banks to change their interest rates (received as well as paid), where they "do not correspond to the economic conditions of the country". This was followed by a decree which came into force on 1st January, 1936, providing for a compulsory reduction of rates. Maximum deposit rates were reduced to 3–3½ per cent. and rates on loans, discounts and advances to legal maxima of 4½–7¼ per cent., according to the nature of the contract, the institution concerned and its geographical situation. The legal control of rates by the monetary authorities is not unreasonable, if they do not otherwise move in sympathy with a controlling bank rate. Some sort of control is essential, if a centralised monetary policy is to be pursued. Canada appears to be one of the few countries where usury laws still exist. No bank may charge interest exceeding 7 per cent.

Responsibility

A tendency noticeable in the newer bank laws is the attempt to increase and define the responsibilities of bank directors. The Swiss law of 1934 and the official report on which it is based have much to say on this matter. The legislators have required that every bank shall have a clearly distinguished management and board of directors

(as is usual in the case of joint stock companies on the continent), each of the two bodies to have definite responsibilities (which are not laid down in the law, but must be precisely determined and approved in each case by the Banking Commission), and a separate personnel. They emphasise, too, that directors and managers are personally responsible for damage or loss due to ill-intent or negligence. In Germany the managers, directors and advisory council of a bank are made liable for the repayment of credits granted to officials and to persons and companies connected with the bank, unless certain conditions are complied with before the loans are granted. The Swedish Bank Act of 1933 goes much further, the purpose here being to prevent directors from leaving major decisions to a management not responsible at law. Certain matters are enumerated which can only be dealt with by the directorate. In Denmark each bank has a board of directors and a board of managers, and the power of the latter to grant loans without reference to the former must be predefined in the bank's constitution and approved by the Bank Inspector. Banks in certain countries have " boards of representatives ", appointed by the shareholders, to act as a check on the directorate. In Denmark depositors also are represented on such boards. In Czechoslovakia the law of 1934 requires a delimitation of the duties of directors and managers. It is probably in this country, also, that the appointment of directors is subjected to the most detailed legal regulation. The contracts of employment of directors and leading officials are limited to a period of two years. Salaries are also subject to legal regulation, and directors are personally responsible, though, of course, only to a limited extent, for the repayment of savings deposits.

Restrictions on the activities of directors and managers are found in almost all countries with banking laws. Directorships in other undertakings are limited or forbidden ; borrowings must be reported or are not permitted at all ; sometimes bank directors are specifically allowed

to act as directors of other banks (Belgium), sometimes this is specifically prohibited (U.S.A.); they may not engage in speculative operations; and where mixed banking is no longer permitted they usually may not manage or direct finance companies, issuing houses, etc.

Many of these provisions are contrary to English practice. In England, for example, the banks seek directors representing as wide a field of experience and influence as possible. The purpose of the particular provisions in question in the various bank laws is (a) to prevent biased or interested action and (b) to secure for the bank its directors' whole time and energies. It is, however, extremely doubtful whether it succeeds in compassing the ends it is designed to meet. Interests in other concerns, for example, are not limited to direct personal interests, and it is difficult to secure by law that a director shall apply himself to his work. In Canada the law requires a record to be kept of attendances at directors' meeting. This is exhibited annually to shareholders, but it is impossible to say whether or not it secures its object.

The American federal and state laws contain many provisions similar to those already described, but the specific responsibility of directors as opposed to managers is not defined.[1] They do not, however, stop at imposing fines and similar penalties for infringements of the law; the act of 1933 empowers the authorities to remove from office bank officers and directors who, in spite of warnings, continue to violate the law or to indulge in unsafe or unsound practices. They have for years had, in addition, the right of suspending banks from membership of the reserve system, but this right has not proved very efficacious. A similar right of removing officials if he considers them to be unfitted for their position is enjoyed also by the German Banking Commissioner.

There is a requirement under many laws that directors shall hold qualification shares. Sometimes under the state

[1] The same may be said of the position of English bank managers under the Companies Act, 1929.

laws of the United States an " oath of fealty " is required or responsible officials must give a bond executed by a surety company. A requirement comparable to the latter, but more exacting, is that found in Italy, where responsible officials deposit guarantee funds at the central bank, in the form either of shares in the bank in which they are employed or of government securities, to cover losses on operations which they undertake *ultra vires.* In Italy, again, is found an unique legal enactment to the effect that a record must be kept of the names of officers sponsoring or recommending loans. A provision similar to that existing in Italy is found also in Germany, where fees, etc. due to managers and directors are not paid to them in full, a percentage being retained by the bank and specially invested. Such sums are only paid out when the official has left the bank, and, even so, only a year after his retirement.

Time alone can show the value of legislation in this field, but it seems doubtful whether it can prove a substitute for naturally honest and prudent management and direction.

Formation, branches, mergers

There is hardly any country which has not suffered at some time or other from an over-extension of banks and banking offices : for instance, Sweden, during the War period ; Canada in post-War years ; the United States in the years preceding the stock exchange crisis of 1929 ; Switzerland probably even to-day (with about 3000 banking offices and a population of only 4 millions). With a view to preventing over-banking most bank laws now give the authorities control over the formation of new banks. In Germany the licensing authority, the Banking Commissioner, may refuse to grant a licence for the formation of a new bank, if the managers are not trustworthy or do not possess adequate professional qualifications ; if such formation appears unjustified on local or general considerations ; or if the business has not sufficient capital

in Germany. In Canada a special Act of Parliament is necessary for the establishment of a new bank, and the charters of existing banks must be renewed every ten years. In Sweden, too, charters must be periodically renewed. In Norway permission to open a bank may be refused for a number of stipulated reasons and has been refused quite recently. In the United States of America the Comptroller of the Currency has considerable discretionary powers in granting charters to new national banks and in 1930 was said to have been rejecting more than half the applications made. Similar control is now exercised over all insured banks by the Federal Deposit Insurance Corporation, the criteria for refusing or granting the admission of a new bank to insurance being much the same as those employed in Germany by the Banking Commissioner. There are, however, few countries to-day in which a new deposit bank would have any very great chance of establishing itself successfully. The concentration of banking, coupled with the extension of branches into remote localities, has made the formation of new banks a comparatively unusual event.

Over-banking is still a danger, however, even in countries which have witnessed a strong amalgamation movement. Indeed, it is in countries which have a few strong banks that the tendency to over-banking, through the temptation to open new branches, is perhaps greatest. In a sparsely populated locality, in which a new unit bank would have little chance of success, a big branch bank is able to open an office, fully anticipating that it will not pay for itself for a number of years. Experience has proved this both in Great Britain and in Canada since the War.

Restrictions on the opening of new branches are imposed in most countries in which banking is legally controlled. In Italy, for instance, no bank may open a branch or agency without permission from the Inspectorate. In Germany a similar provision exists, but it applies only to banks formed after 1935. In the United States there are important restrictions on branch banking,

but the purpose of these is not so much to prevent over-banking as to maintain, for political reasons, a unit banking system. In Norway branches may only be opened within the municipality in which the head office is situated, unless special permission is obtained. In most developed countries, however, even the extension of banking facilities through the opening of branches has now reached or is reaching its limit.

Thus, important as it is in theory that there should exist a central control over the number of banks and banking offices opening their doors for business, whether the safeguarding of the banks themselves against ruinous competition, or the protection of the community as a whole, be considered ; yet it appears that in most countries natural forces, just as much as legal regulations, are to-day largely responsible for any satisfactory results that have been achieved in this direction. The outstanding exception, of course, is the United States of America, where the powers conferred on the authorities for the prevention of over-banking are among the most important features of the different banking laws. Generally speaking, however, in other countries the position of the banks which have survived is now so strong that new competitors have little or no chance of success. Probably more valuable than the authority to control the formation of new banks is the power to terminate the existence of those which are not properly conducted. It will be noticed, in succeeding chapters, that this right is now quite commonly assumed by the supervisory authorities. Its value lies, not in the fact that it constitutes a threat, but in that it affords the authorities the opportunity of winding up or changing the management of an unsound bank before the savings of the bank's depositors have been too severely compromised. Concentration may also be achieved by a refusal to renew permits or by the withdrawal of permits, and a number of the smaller Italian banks have been eliminated in this way in recent years.

Bank amalgamations, also, are nearly always controlled

by law. In Norway the consent of the Crown is required; in Sweden official permission must be obtained and is only granted provided that the amalgamation is not contrary to public interest. Even in England a government sanction is required. The aim has doubtless been the same in all three countries: to prevent too great a concentration of power and to keep alive a certain measure of competition. In the United States mergers are, in fact, restricted through the legislation directed against branch banking; affiliation is a more common means of pooling resources and extending control.

In contrast to the countries mentioned in the last paragraph the authorities in Japan and Czechoslovakia have gone out of their way to encourage amalgamation. The Japanese banking system, in particular, is still characterised by the large number of its component units; a conscious policy of concentration has, however, been pursued by different governments for a number of years, and this is resulting in a gradual westernisation of the banking structure.

Universal as are the laws restricting the formation, amalgamation and branch banking activities of commercial banks, it cannot be said that they have generally exercised any great effect upon the banking structure of the different countries. They have usually been introduced when the movement which they were intended to check had run its course.

Attention may be briefly directed here to the legal form which banks have been compelled to assume under certain laws. Although in a number of countries banks may operate under any of a number of forms, for instance in Germany or Switzerland, yet a tendency to standardise the legal constitution of banks is noticeable elsewhere. In Norway all banks must be limited companies and offer their shares for sale publicly.[1] In Sweden, under the

[1] Co-operative societies, which may accept deposits from their members, are not regarded as commercial banks and are subject to special legislation

Bank Act of 1911, banks were required to be joint stock companies (with either limited or unlimited liability), while as a result of legislation in 1934 all the banks with unlimited liability have now become limited liability companies. In Denmark banks may only be formed as limited liability companies. Thus in the Scandinavian countries a complete uniformity of constitution has been achieved.

Other countries have made tentative steps in the same direction. In Belgium, since 1935, the formation of banks as credit associations or co-operative societies has been prohibited, while in Switzerland no banks may be formed as co-operative societies.[1] In Canada all commercial deposit banks are chartered joint stock companies and in Great Britain no banking partnership of over ten partners is permitted. There is much to be said for some measure of constitutional uniformity in enterprises which engage in the same business and are subject to the same legal requirements in many matters. Further, banking is to-day best carried on by large institutions, and the legal form which seems most suitable for this purpose is that of the limited liability company.

Liquidating institutions

Many of the banking laws considered in this book were passed in the years 1933–35 and based on the experiences of the preceding three or four years. While, however, they should do something to prevent the recurrence of the events of those years, they were not intended to remedy the existing situation. In many cases special liquidating institutions were established. It is proposed to compare some of these in brief, because they represent a new departure in banking and because, although intended to be temporary, may well in some instances develop into permanent institutions. It has been an unfortunate experience that, during the crisis, many central banks have been unable to live up to what the text books have ex-

[1] This is directly attributable to the failure of the Schweizerische Volksbank in Berne a few years ago.

pected of them. Whether or no some of the central banks have not been very efficient " lenders of the last resort " because they were not equipped as they should have been or because commercial banks presented them with impossible situations, cannot be discussed here. It is sufficient to note that there now exist a number of special institutions in different countries to which commercial banks will in future look to help them out of their difficulties.

One of the most important of such institutions is the Reconstruction Finance Corporation, founded in the United States in February, 1932, with a capital of $500 millions. It has aided banks very considerably, partly by furnishing new capital where capital was deficient, partly by making loans against assets which were not eligible for rediscount at the federal reserve banks. It will be seen that in return the R.F.C. has acquired a by no means negligible degree of control over the banks it has helped and is still helping. Even earlier than the R.F.C. were the German Finanzierungsinstitut and Tilgungskasse, formed after the crisis of 1931 to take over frozen assets from the banks.

In the Argentine one of the banking laws of March, 1935, created the Instituto Movilizador, with a capital of 10 million pesos and reserves of 380 million pesos, with the object of taking over the frozen assets of the commercial banks and realising them over a period of years. In less than a year almost the whole of this sum had been expended. Four banks were reorganised to form one new bank, of which the Institute owns a quarter of the capital, with special voting rights. In Belgium the Institut de Réescompte et de Garantie was created in June, 1935, for the purpose of aiding banks and industrial, commercial and agricultural enterprises to mobilise their assets. Its life is to be five years, its capital 200 million francs subscribed by banks and bankers, and the guarantee of the state on its operations is fixed at 2000 million francs.

In Mexico the Nacional Financiera S.A. was established in 1934, partly to take from banks such credits and securities as the banking law of 1932 prohibited their

holding. In Austria a Revisionsgesellschaft was established in 1933 with a capital provided by the government and National Bank, for the purpose of taking over frozen bank assets in order to prepare the way for reorganisation. This institution, however, has now finished its work, and the frozen assets have been handed back without any compensation from the banks. In Switzerland the state established in 1932 a Caisse des Prêts, with a guarantee fund of 100 million francs, to make advances to banks against illiquid assets. In Italy the Società Financiaria Industriale Italiana and the Istituto Mobiliare Italiano have between them performed a similar function, while the Istituto per la Recostruzione Industriale has been organised to take over industrial participations from the banks. In Brazil the Banking Mobilisation Fund was founded in 1933 and had by the end of 1934 given credit to the banks to the extent of 54 million milreis, with a view to facilitating the progressive mobilisation of frozen bank assets.

These institutions, which in most cases obtain funds from governments or through the issue of bonds, usually work in co-operation with central banks, but in so far as they remain separate entities must to some extent diminish the prestige of those authorities. It appears that a number of them will not be liquidated for some years, and, should another depression intervene, they may become permanent institutions and develop into regular and recognised elements in the various banking systems.

The machinery of control

This introduction would not be complete without some comparison of the different authorities which have been created to dispense the law. As might be expected, there is wide variety both in the manner of their constitution and in the extent of their functions and powers. These variations are due not merely to differences in the various banking systems themselves and in the degree of control imposed by the central authorities in the different coun-

tries, but are also a reflection of differences in political and social traditions.

Three main types of institution may be distinguished. Firstly, there are the Inspectorates common to the Scandinavian countries. In Finland the Inspectorate is appointed directly by and is responsible to the Ministry of Finance. In Sweden, Norway and Denmark the head of the Inspectorate is appointed by the Crown and works in close contact with the Ministries of Finance or of Commerce. The Inspectorates are, in fact, little more than specialised departments of these Ministries and exercise only restricted powers *per se*, for the bank laws of these countries form in the main a fairly rigid code, and, where the exercise of discretion is provided for, it is usually allowed to the Ministry concerned rather than to the Inspectorate. Control is exercised by the state, and formally neither the central bank nor the commercial banks have any voice in it. What has been said of the Scandinavian Inspectorates may be said also of the Canadian Inspector General of Banks, and much the same applies to the Japanese Bureau of Banking of the Finance Department.

It is otherwise in such countries as Belgium and Switzerland, whose commissions exemplify the second type of institution. It will be noted at once that they are commissions composed of several members, not inspectorates composed of a director and his subordinates. In Belgium the Banking Commission is an autonomous corporation consisting of a president and six members nominated by the Crown ; two members are selected from a list drawn up by the banks and two from a list drawn up by the central bank. In Switzerland the Banking Commission consists of five members appointed by the Federal Council. There is no formal contact with the central bank, although, curiously enough, the National Bank performs a number of controlling functions under the bank law. The Banking Commissions of these two countries enjoy far more extended powers than the Inspectorates in Scandinavia.

Thirdly, there are the highly centralised institutions of Germany and Italy. Both countries have introduced an extremely detailed system of regulation which was intended to bring banking policy under state control. In order to ensure flexibility it was necessary to lay down general principles in the main law and to leave the detail to be filled in by executive orders. In Germany control of the banking system is in the hands of a Board consisting of the President and Vice-President of the Reichsbank (who are chairman and deputy chairman respectively), a nominee of the Leader and Chancellor, and the Ministers of Finance, Commerce, Agriculture, and Home Affairs. In Italy the Committee of Ministers, which has supreme authority over the banking system, consists of the Head of the Government and the Ministers of Finance, Agriculture and Forests, and Corporations.

Broadly speaking, these two bodies are responsible for general policy. Under them is the organisation dealing with day-to-day supervision. In Germany the Banking Commissioner is appointed by the Leader and Chancellor on the advice of the President of the Reichsbank : in Italy the Head of the Inspectorate is the Governor of the Banca d'Italia. Thus in these two countries there is found a type of organisation which embraces the government, the central bank and the inspectorate, and makes any conflict of policy impossible. In as much as, in both Germany and Italy, the powers of control are extensive, the banking system may be regarded as having been nationalised in all but name.

It may be added that in the Argentine no commission or inspectorate of any sort exists. Control is entirely in the hands of the central bank.

In the United States there are a number of controlling authorities, as will be seen, but the Board of Governors of the Federal Reserve System is pre-eminent.[1] Its seven

[1] The Comptroller of the Currency, who supervises national banks, is in some ways more comparable to most of the bank inspectorates. He, too, is nominated by the President. For an account of his functions in detail, see p. 383.

members are appointed by the President of the United States, with the approval of the Senate, but, in spite of much that has been written to the contrary, the Board is comparatively free from political control, especially in matters affecting banking as opposed to credit policy.

The primary function of all inspectorates and commissions is to see that the law is observed and to take action against, or report to the appropriate judicial authorities, any shortcomings or transgressions. The Board of Governors in the United States, as has been observed, has the power to suspend its member banks from the privileges of membership of the system, and to dismiss officers and directors; but banking commissions are rarely given such extended authority. In Belgium, for example, authority is limited to instructing the National Bank to make investigations, and in Switzerland to reporting infractions to higher authorities. In Sweden and Germany, however, the Inspectorate has the right to impose fines. In Japan the Minister of Finance has very wide powers. He can suspend a bank; order the deposit of any of its assets with himself; replace all or any of its directors, if it commits an act "calculated to prejudice public welfare"; and replace a bank's auditors. In Belgium, Czechoslovakia and the United States action is taken against unsound practices as well as against violations of the law. How effective this is, in practice, is uncertain. It would certainly seem to raise some difficulties, especially concerning the competence of a commission to condemn, as being unsound, practices with which experienced bankers are themselves satisfied. While, however, there must be a number of situations and practices upon which judgment can only be arbitrary, such authority does have the merit of bringing to light and punishing deliberate malpractices.

The second main function of commissions is to receive returns; to decide whether or not any particular institution is a "bank" within the scope of the law and to publish lists of "banks"; to approve the memorandum and

articles of association or charter of new banking institutions; to control bank amalgamations; to require copies of examiners' reports, where they do not themselves examine, and so on. They act, in short, as registrars of banking companies, and perform an important service in controlling the establishment of new banks.

A third function discharged by bank commissions is the modification of general provisions of the law in matters which the law itself has left to their discretion. For example, the Swiss Commission may modify liquidity requirements in special cases; the United States Board of Governors may give special permission to bank directors and officers to serve in other banks, and still wider powers are given to the German Supervisory Board. Duties of this sort may be considered among the most important of those entrusted to supervising authorities, for banking is a business for which it is difficult and often undesirable to lay down hard-and-fast rules, and anything which makes for reasonable flexibility is usually to be commended. It might be added that the strength and importance of a banking commission can be gauged by the number and weight of its discretionary powers.

Most commissions are connected in some way with bank examinations. Some have their own force of examiners (as in Denmark, U.S.A. and Sweden). In Belgium and Switzerland they supervise the activities of the specialised bank auditors. In Belgium the *reviseurs* or bank auditors are appointed by the banks themselves, but subject to the approval of the Commission, and it is to the Commission that they report continued irregularities. The Swiss Commission has similar relations with the auditing associations (*syndicats de revision*),[1] which are not nominated by the banks, but exist independently of them. The banks have, however, the right to choose which association shall

[1] Somewhat similar to the *syndicat de revision* is the examining force of the New York Clearing House Association, to whose examinations members of the House voluntarily submit. There are, however, comparable organisations in Hungary and Czechoslovakia, the former voluntary, the latter organised by the state.

examine their accounts. In Canada the Minister of Finance controls the list of auditors authorised to audit the accounts of banks. In Germany all banks are subject to a periodical audit, the rules of which are to be determined by the Supervisory Board.

Other extended powers will be noted in the following pages, but a few examples may be given here. In Norway the Inspectorate can summon a meeting of directors or even an extraordinary general meeting of a bank. The Belgian Commission can fix maximum rates of interest for certain credit transactions, forbid public issues of capital (for third parties) of longer terms than five years, and exercise general supervision over the capital market. The powers of the American authorities, however, far outweigh those of the authorities in other democratic countries, though they are still perhaps not as great as those found in totalitarian states.

The expenses of the supervising authority may be borne either by the banks (directly in Denmark, Sweden and Germany, indirectly in the United States), or by the government, as in Canada, Switzerland and Belgium. It would seem preferable in principle that they should be borne by the state, partly because this makes the commission more independent of the banks,—though indeed less independent of the government,—but chiefly because it seems inequitable to make the banks bear the cost of supervision imposed for the protection of the community at large. It will be noted later how severe is the burden which has been imposed on many American commercial banks.

In a democratic country an efficient commission, it will be evident, must have certain characteristics. It must be independent, both of political influence and interference and of the banks it controls. It is for the latter reason that practical bankers are usually excluded from membership of the commissions. A commission must be technically competent (and for this reason members are sometimes required to have had banking experience); most of the

laws contain provisions to secure competence, though there has been a complaint in the United States that examiners are not always endowed with the ability to judge the value of assets, the worth of which it is one of their duties to assess. Thirdly, an efficient commission must have adequate powers, both to investigate and to reprimand. Powers to investigate are usually far reaching, and it has already been seen that adequate powers of taking action of one form or another are usually given; either of suspension, the infliction of penalties, denunciation to higher authorities or, in one or two cases, the publication of unfavourable reports. Most of the commissions and inspectorates are well enough equipped to perform their work.

There can be little doubt that the existence of a strong independent commission must to some extent have the effect of diminishing the central bank's power and prestige. Banking control and credit control may be different matters, one being qualitative, the other quantitative, but it is in practice difficult to say where one ends and the other begins. Central banks are no longer in many countries the supreme authorities they once were. Even so, recent laws have in some ways increased their powers and responsibilities. The new Argentine central bank has been given exceptionally wide powers. The Swiss National Bank has acquired the power to veto big foreign loans and to advise against the raising of rates of interest on short-term bank debentures. In Belgium it is to the National Bank that the Banking Commission has to report violations of the law, though this is poor compensation for the economic powers which the Commission has been given in the capital market and in fixing maximum rates of interest. In Sweden the central bank has been given no increased powers in recent years, but it has exerted a stronger moral control than ever. Lastly, the increased powers of the federal reserve banks and Board are given to them as much because they are central banking authorities as because they fulfil many of the duties of a

bank inspectorate. It would, however, be idle to assert that, the world over, central banks have the same reputation and prestige as they had prior to 1929. The mere establishment in so many cases of separate commissions and inspectorates is evidence of this.

Conclusion

In order to pass a verdict on the legal control of commercial banking, the circumstances in which such control has been introduced must first be considered. In some cases the initiation of control has been of an *ad hoc* nature, designed to remedy serious abuses and malpractices which have made themselves evident at a time of crisis, as in America in 1933. Sometimes it has been designed merely to extend to all banks practices already followed by the best banks, as in Switzerland. Sometimes, as in Canada, a reconsideration of the banking system is periodic and automatic. Sometimes it is part of a general scheme of economic planning, as in Germany and to some extent in Italy. Lastly, commercial bank control has in some cases been introduced and justified as embodying certain principles, the validity of which has seemed self-evident. Thus the report accompanying the Royal Decree of 9th July, 1935, in Belgium states :—" The opening of accounts by banks has become so important a function that the authority charged with safeguarding the working of the economic system cannot but interest itself in the internal structure of institutions which have become nationally so important. The rôle of the banks has grown to the point at which any serious weakness in a deposit bank has immediate and often unforeseeable repercussions on the economy of a whole country." Or again, the Swiss report of 1934 :—" The outstanding fact which characterises the modern economy is perhaps less the phenomenon of the concentration of wealth than the centralisation of a considerable economic power in the hands of a small number of persons who do not own the money at their disposal, but merely have it deposited with them. Thus banking

activity has become a sort of public service, and it is consequently quite natural that a certain number of countries have already put into force measures for the supervision of financial institutions." Those who advocate the nationalisation of banks in this country have also made such arguments familiar and they are found in the preambles of a number of banking laws. In very few cases, however, have legal provisions yet gone beyond the point of attempting to safeguard individuals,—depositors and shareholders; the stage of directing the funds held by bankers into channels conceived to be nationally desirable has not yet been reached, though a case for it can be made out. Thus although the establishment of conditions permitting the enforcement of a general credit policy has been one of the objectives of legal regulation, main emphasis has been placed on the maintenance of a high standard of banking practice.

What are the dangers inherent in bad banking? First, if deposits are lost or frozen, individual depositors may be ruined, and where the individual depositors are industrial or commercial companies, unemployment may result. Secondly, shareholders themselves may suffer. Thirdly, borrowers may find that the sources of credit dry up, and trade and industry may be deprived of their working capital. Fourthly, a sudden liquidation of assets on a large scale may provoke a rapid fall in the prices of the real or personal property,—land, securities, goods,—held by the banks as assets or collateral. Fifthly, a reduction in the volume of the most important medium of exchange may precipitate deflation. In short, a series of bank failures, perhaps even the failure of a single big bank, might have serious consequences, not only for depositors and shareholders, but also for the public at large. In so far as these dangers are real, there appears to be a good case for legal regulation, yet a consideration of the admittedly successful banking systems of Great Britain, France and Holland shows that there is no *a priori* need for a detailed legal control. Particular circumstances may,

in any country, make the statutory regulation of banking inevitable, just as they may make the regulation of any other important activity inevitable, but the justification for such control is purely *a posteriori*.

A question quite different from the justification of the principle of control is the efficacy of the various codes from which control derives. Here it is difficult to make a general judgment. Few of the banking codes in existence before the last depression were entirely successful in mitigating that depression ; the numerous banking laws passed during or since the depression have yet to prove their worth. The test can only be empirical. Some of the provisions referred to in this preliminary chapter and dealt with at greater length in succeeding pages represent merely the enforcement by law of what were already recognised to be sound banking principles ; restrictions on various kinds of asset ; adequate capitalisation ; limitations on loans to one customer, and so on. Other provisions do not equally commend themselves, especially many of the petty details designed to secure competence and honesty on the part of directors and managers. For example, the exaction of financial guarantees from such officials, the limitation of the number of companies in which they may hold directorships and the imposition of legal penalties for undefined " unsound " banking practices can be only of limited practical value. An honest and competent management cannot be attained by legal enactment, but rather by proper methods of recruitment and training, proper remuneration and conditions of work, and a system which gives wide scope and high prospects to the talented. It is here that the British banks have succeeded while those of certain other countries have failed. So, too, an honest and efficient internal inspection system obviates the need for government examinations. It is believed that, even in countries where legal regulation is most detailed, the ultimate success and efficiency of the banking system will be due more to the growth of such traditions in the banks themselves than to external control. Past experience

has made this evident, for it has frequently happened that under the same banking law one of two banks has failed, while the other has emerged intact from the same crisis.

Control by legislation, in any field, has its disadvantages. The chief of these is the division of responsibility, which is inevitable. If the law prescribes the observance of certain rules, it cannot logically censure any weaknesses which develop in spite of the strict observance of such rules. The more definite the prescriptions of the law, the more is this the case. In framing legal regulations the state takes responsibility on itself and relieves the subject of it. The legislators may, as in Switzerland, think that, by establishing a commission which is not a government department, the state avoids responsibility, but in fact it cannot. Or they may, as in the United States, state that bankers are still liable in respect of " unsafe and unsound practices ", thus hoping to cover any possible omissions in the law ; or, as in Belgium, arrange that the Banking Commission has no force of examiners of its own, but merely approves the names of auditors chosen by the banks themselves, so that it may avoid direct responsibility ; or, as in Canada, state that the government undertakes no responsibility to depositors, creditors or shareholders for any default, negligence, mistake, error or omission in the administration of the powers or duties of the Inspector General of Banks. But the state cannot both enjoy control and evade responsibility.

A second difficulty with legal control is that banking above all is a business which calls for the use of judgment and discretion, and that a statutory percentage is not a good substitute for such discretion. In this connection three facts must be taken into consideration. Very seldom are the two sets of circumstances in which two loans are made, or two parcels of security taken, or two accounts worked, identical. Practically every factor in every department of banking is an independent variable, and conditions are constantly changing. Flexibility is therefore a great asset. Again, banking is a business from which

risk cannot be excluded. If banks are to fulfil their proper functions, they must take risks which cannot be insured against, or actuarially calculated. The law cannot safeguard any enterprise against risk; risk is inherent in all enterprise. Thirdly, there are some risks which are proper to banking and others which are not; but there is no distinct line between the two, and whether or not a given risk is one which a banker may legitimately take cannot generally be decided by rule of thumb. Provision, as has been seen, is frequently made for the use of discretion by the supervising authorities, but there must always remain a number of matters on which the banker has been deprived of the use of discretion and the commission or inspectorate not been given it.

Much importance is sometimes attached to the uniformity imposed by legal regulation, but too much uniformity has its disadvantages. For example, in some countries rates of interest on deposits and loans are fixed by a central authority which has no powers to vary these rates in the case of an individual bank, even less in the case of an individual loan. There appears to be no legitimate reason why a bank should not grant specially favourable terms to a customer who has introduced business to the bank, or who does not take advantage of the free services offered. So, too, one loan may involve a greater risk than another and yet still be a good banking risk; as such, it should earn a higher rate of interest than less risky loans. Similar arguments might be applied to cash reserves; there must be quite big variations not only in the turnover of demand deposits, and in the proportion of demand to total deposits, but also in the nature and shiftability of secondary reserves. Or to surpluses, for of two banks with a similar volume of deposits one might have a much larger capital than the other, even if there existed a legal minimum capital which both observed, and one would thus not need so large a surplus as the other: yet the very bank which had the larger capital would by law be required to establish a larger surplus (surplus being

usually fixed as a percentage of paid-up capital). Such considerations as these are not put forward as arguments against legal control, for they may be outweighed by corresponding benefits. They do, however, modify the value of the advantages gained from statutory regulation.

Although the legal regulation of banking has taken place in some countries where there is a considerable measure of banking concentration, for example, in Germany and Canada, it becomes evident that such regulation is in many respects an alternative to concentration. The existence of a large number of banks makes close contact between the authorities and the banks extremely difficult, and understandings between the banks themselves not very much easier. The legal code takes the place of the " gentlemen's agreement ", the legally fixed rate of interest that of the cartel rate. The directors and managers of unit banks, too, seem in general to have less sense of responsibility; and that uniformity which is imposed from within in a branch banking system has to be replaced by statutory regulations, which, of necessity, are inflexible and admit of little or no discretion.

Such considerations as these, apart from the high standards of the banks themselves, would make the detailed legal regulation of banking superfluous in this country. This might be said also of certain countries in which concentration has come about since the adoption of a banking code. In such countries, although control by law exists, the gradual development of a high banking tradition is the factor on which future achievements mainly depend.

THE ARGENTINE

THE ARGENTINE

The banking system and its defects

THE Argentine Government in 1935 introduced legislation completely reorganising the financial system of that country. Of this legislation, we are here concerned only with the laws directly affecting the banking system. These are the Banking Law, various sections of the Central Bank Law and the law establishing a liquidation institute for the realisation of the frozen credits of the commercial banks. The result of their application has been the entire reconstitution of the former unco-ordinated system, which was inherently unstable, into a closely knit banking system, purged of its frozen assets and controlled by a central bank to which the task of enforcing the detailed provisions of the laws has been entrusted. A complete code of laws regulating the day-to-day activities of the banks in the broad interests of the public has thus been established. Before a detailed discussion of them is undertaken, however, it would be well to consider why it was deemed necessary to introduce such far-reaching control over the banks.

The Argentine banking system suffered from two main defects, each of which tended to aggravate the severity of the other. There was no uniformity amongst the constituent units. Some banks were foreign institutions, specialising in foreign-exchange operations; others were local institutions concentrating mainly on the financing of agriculture and of extractive and preparative industries; between both classes of banks, and amongst banks of the same class, there was keen rivalry, resulting in the adoption of undesirable methods of attracting business. There was

no norm of banking conduct such as exists, for example, in England. Secondly, no central bank existed to undertake the general control of monetary and banking policy, and to support the banks in case of necessity. Responsibility for the note issue, rediscounting and the carrying out of governmental monetary aims was unequally divided between various government departments and the Banco de la Nacion Argentina. The net effect was that banking in the Argentine was exposed, not only to the grave dangers of excessive competition between banks unfettered by any special banking regulation, but also to the difficulties (which would be grave enough even in a well-organised system), peculiar to countries such as the Argentine, which are largely dependent on the sale abroad of agricultural commodities and the import of foreign funds for purposes of capital development.

In 1925 there were in operation 113 banks, of which 91 were commercial. Of these 91 banks, 3 banks (each of which possessed a capital of more than 40 million pesos), namely, the Banco de la Nacion Argentina, the Banco de la Provincia de Buenos Aires and the Banco Español del Rio de la Plata, held between them half the capital and reserves of all the commercial banks, and transacted about half of the banking business of the country. The seven largest banks (including the three mentioned above), with a capital of 20 million pesos or more each, transacted about two-thirds of the banking business.[1] Moreover, there was a considerable diversity of function, mainly due to the historical evolution of banking in the Argentine. There were the foreign banks, which specialised in the financing of the import and export trade ; the large Buenos Aires banks with a well-developed branch system, which were concerned mainly with the finance of internal trade, together with mortgage operations and industrial finance ; and the small local banks, which were dependent on the industries of the districts in which they were established.

[1] *Memorandum on Commercial Banks, 1913–29.* League of Nations, Geneva.

Directly arising from the large number of banks and the absence of controlling legislation was the prevalence of cut-throat competition for business. Apart from an agreement to furnish government departments with statistics, the banks had no collective legal responsibilities or common standards of conduct. There was no tacit agreement, for example, to limit the rates of interest payable on deposit accounts or chargeable for loans or overdrafts. Each bank was free to fix its own rates with the consequence that, on the one hand, the banks were led into offering too high rates for deposits and therefore incurring heavy outgoings, which could only be covered by making speculative investments, while, on the other hand, loan and overdraft rates were forced up to inordinately high levels. Such practices were a continuous source of weakness to the system as a whole. In September, 1933, the Minister of Finance was compelled to intervene and suggested the conclusion of an agreement amongst the banks to establish maximum rates of interest of 5–5½ per cent. for discounts, and 6–6½ per cent. for current-account advances. After six months, however, the agreement was allowed to lapse, and each bank once more fixed its own rates.

The lack of a central bank was an equally grave drawback. While it is true that the Banco de la Nacion did undertake some of the functions of a central bank, in rediscounting bills and making advances to other banks, yet it was at the same time carrying on a purely commercial banking business. At times, the interests of the Banco de la Nacion, acting in its capacity as guardian of the currency, did not coincide with its interests as a profit-making institution; in these circumstances it was only natural that national interests suffered. The necessity for a strong central bank, able to control money-market fluctuations and to afford assistance to the banks if required, was particularly urgent. As Sir Otto Niemeyer pointed out in his Report in 1933, it is essential that the banking system of a country so subject to violent economic

movements as the Argentine should be strong enough and flexible enough to withstand such fluctuations, without dislocating the whole economy of the country. Although the banking system had, in fact, evolved a rudimentary technique of sterilising gold movements into and out of the Argentine, yet the lack of a central institution in the post-War years of depression, coupled with bad government finance, had materially weakened the liquid position of the commercial banks.

The Niemeyer Report

In 1933 Sir Otto Niemeyer was invited to investigate the whole financial system and to suggest measures for its reform. He suggested that two innovations were essential. In the first place, a central bank should be established to coordinate the scattered elements of a central bank which had been created from time to time by the government to control the note issue. The existing system was very clumsy and complicated, and required thoroughly reorganising.

The old monetary system was a purely automatic one; the Caja de Conversion, established in 1899, exchanged paper into gold and *vice versa* at the rate of 2·2727 paper pesos for one gold peso. Operations were suspended at the beginning of the Great War, recommenced in 1927, but again suspended in December, 1929, at the onset of the world economic depression. The Caja de Conversion did not undertake banking functions. To introduce some element of elasticity during the first period of the depression, the government set up a Rediscount Commission charged with the task of issuing notes against commercial documents such as bills of exchange; here again, however, no control of credit was possible, since the Commission was not able to work on the money market. Next, a Board of Amortisation of the Patriotic Loans (Emprestito Patriotico) was created to issue notes against bonds; in this case, too, no control of the general credit situation was possible. Finally, in November, 1933, an Exchange Control Commission was formed to regulate the foreign ex-

changes. In addition to these autonomous institutions, the Banco de la Nacion was carrying out operations which properly belonged to the sphere of central banking and hindered the bank's own purely commercial business.

Sir Otto Niemeyer recommended that a central bank should be set up to replace these autonomous departments, by becoming solely responsible for the note issue, to take over the regulative tasks of the Banco de la Nacion and to exercise extensive powers over the commercial banks, both by its operations in the money market and by its control through a proposed banking law.

His second principal recommendation was that general banking legislation was necessary, if the Argentine banking system was to function efficiently and safely. Since his proposals to this effect were used by the government, in an amended form, as the basis of the banking legislation of 1935, it is of interest to examine them briefly, together with the relevant proposals concerning the powers of the central bank.

The provisions may conveniently be dealt with under two heads :—

(1) The control of the central bank over the money market and the general operations of the commercial banks. The capital of the central bank was to be subscribed entirely by commercial banks, both native and foreign, provided that their capital was not less than one million pesos ; any banks founded subsequent to the establishment of the central bank, or any banks already in existence which increased their capital to the minimum required, were also to subscribe. The Banco de la Nacion was to transfer to the central bank all clearing balances of the commercial banks, together with the accounts of the Federal Government and autonomous departments and the judicial accounts. As regards money-market functions, the Banco de la Nacion was to be relieved of its responsibilities in this direction, and the central bank was to be

empowered to discount eligible bills of exchange for shareholding banks, and to make advances to them at a rate fixed at least one per cent above the rate of rediscount for three months' bills.

The central bank was also to be placed in charge of the clearing system, of which the compulsory balances held by the shareholding banks with the central bank were to form the basis. These measures were designed to give the central bank a large measure of control over the money market and general credit policy.

(2) Regulation of the commercial banks. Companies and individuals were to conform to certain conditions before being entitled to use the words " bank ", " banking " or " banker ". No new bank was to be established in the Argentine without a paid-up capital of at least 1,000,000 pesos. Every bank was to maintain a cash balance equal to at least 20 per cent. of its sight balances and 10 per cent. of its time deposits ; at least one-half of these balances to be kept at the central bank. In order to stamp out unsafe competition, maximum rates of interest, payable on time and sight deposits and regulated according to the current discount rate of the central bank, were to be observed.

Further, in order to safeguard the depositor, various operations were to be forbidden to the commercial banks :—

(a) To retain or purchase real estate not required for the use of the bank in question ; or to a value exceeding 10 per cent. of the paid-up capital and reserves. Any property held in excess of this limit or acquired subsequently was to be gradually liquidated.

(b) To purchase or possess shares or bonds of a single company for an amount exceeding 20 per cent. of the capital of that company, or invest in shares or bonds of any single com-

pany sums in excess of 10 per cent. of its own capital and reserves.

These two prohibitions were designed to prevent the banks from immobilising their funds in long-term credits or in illiquid investments (faults which were not, in point of fact, altogether absent from the Argentine banking system) and with a view to effecting a spread of assets.

(c) To accept bank shares as security from another bank.

(d) To receive savings deposits in excess of 20,000 pesos from any one customer, or, in the case of co-operative mutual benefit societies, in excess of 50,000 pesos. These deposits were not to be repayable at less than 30 days' notice.

Finally, every bank was to publish a balance sheet and profit-and-loss account within one month after the close of its financial year, in addition to submitting monthly statements to the central bank, of which only the summaries would be published.

The carrying into force of these two main proposals was to be entrusted to an Organisation Committee with powers to introduce all measures necessary to establish the central bank and the new monetary system, and to put the provisions of the banking law into practice.

The Banking Laws of 1935

Although Sir Otto Niemeyer considered that the reforms should be introduced as soon as possible, proposals for legislation were not submitted to Congress until the end of 1934. These passed into effect, with minor alterations, on 28th March, 1935.

The laws were :—

(1) The Central Bank Law No. 12,155, which established the Banco Central de la Republica Argentina as the supreme monetary authority in the republic.

(2) The Banking Law No. 12,156, which introduced a new banking régime for the commercial banks.

(3) The Law No. 12,157, setting up an Institute for Liquidation of Bank Investments (Instituto Movilizador). The object of this institute, which closely resembles the German institutions established for the same purpose in 1933, was to take over illiquid assets from the banks, in exchange for cash and/or redeemable bonds.

(4) The laws modifying the statutes of the official banks: Law No. 12,158, altering slightly the administration of the Banco de la Nacion: Law No. 12,159, governing the administration of the National Mortgage Bank.

(5) The Law of Organisation No. 12,160, setting up a body of experts to issue the necessary detailed decrees relating to the establishment of the central bank, the Instituto Movilizador, and the new Banking Law.

Although we are concerned with the regulation of the commercial banks, a consideration of Law No. 12,156 by itself would not give a complete idea of the extent to which the banks are in fact controlled. The correct relationship between the laws from our standpoint may perhaps be expressed thus. The Banking Law itself lays down regulations with which every commercial bank must comply, both as regards establishment and the conduct of business. The law establishing the new central bank gives the central bank power over the commercial banks through the control of the money market and entrusts it with the task of ensuring that the day-to-day operations of the banks do not contravene the provisions of the Banking Law. To provide the banks with adequate cash reserves by relieving them of their frozen assets, Law No. 12,157, created the Instituto Movilizador. Finally, the Law of Organisation laid down the procedure by which all these reforms were to be made possible; namely, by the

utilisation of the profit of some 700,000,000 pesos, arising mainly from the revaluation of the gold stocks held by the Caja de Conversion upon their transfer to the central bank as basis for the new note issue. With Laws Nos. 12,158 and 12,159, governing the administration of the two official banks, we are not here concerned.

The essential feature of these regulations, and one which was stressed in the commentary accompanying the projects, when they were submitted to Congress at the end of 1934, is the principle that the commercial banks have a great responsibility, not only towards individual depositors, but towards the nation as a whole. The attempt has been made to apply this principle in practice: first, by placing the banks in a liquid position by relieving them of their frozen assets; secondly, by laying down certain rules regarding the constitution and operations of the banks; and finally, by ensuring the faithful observance of these rules by instituting a system of control and inspection under the aegis of the central bank.

It was considered, following the recommendations of Sir Otto Niemeyer, that there were two overwhelming advantages in favour of entrusting the work of supervision to the central bank rather than to a special state department as had been suggested in some quarters. In the first place, the central bank, when rediscounting bills and other paper, or advancing money against them, would be obliged to scrutinise every name on the documents very carefully. It would therefore be convenient and would obviate duplication, if this information could be utilised in other spheres. Secondly, it was considered that the administration of the laws would most probably be more efficient if conducted by the central bank than if entrusted to a government department which might have less liberty of action. Such control, too, would be likely to be enforced with a greater freedom from friction if exercised by the central bank.

Establishment of commercial banks

Under the Banking Law No. 12,156, as regulated by a decree passed on 8th August, 1935, the right to carry on banking business (banking being defined as business principally dependent on the acceptance of time or sight deposits) is subject to the consent of the government upon the recommendation of the central bank. No person or corporate body is allowed to use the word " bank ", " banker " or " banking " unless this authorisation has been given. A further, though negative, definition of banking is given in the same regulatory decree:—"Any institution which discounts commercial documents or makes advances on current account for a period greater than 270 days, whether or not a mortgage guarantee is taken, will not be regarded as carrying on banking business ". Hence, a commercial bank, under this section, can only make advances up to a maximum period of 270 days.

It may, perhaps, seem strange that these powers have been placed in the hands of the government and not in those of the central bank. According to the official commentary on the law, however, the legislators considered that a decision by the government would be more representative of the true public interest.

In accordance with the provisions of the law relating to the formation of a central bank, a list of all the banks in the country with a capital of one million pesos or more was compiled, in order to ascertain how many shares in the central bank's capital each of the commercial (member) banks would have to subscribe. These banks, whose status was automatically examined and approved, numbered fifty and were composed as follows :—

Banco de la Nacion Argentina
9 provincial or mixed banks
28 national banks
12 foreign banks.

Since the date when the allotment of shares was first

made, changes in membership have taken place. The Banco Español del Rio de la Plata Ltdo., formed early in 1936 to take over the banking business of the old Banco Español del Rio de la Plata, the Banco Hogar Argentino, Tornquist y Cia and the Banco Argentino-Uruguay, has assumed the central-bank shares held by the above banks, while the three latter institutions, no longer regarded as commercial banks, have been required to develop on special lines. Two shareholding banks, the Banco Escandinavo Argentino and the Banco Italo-Español-Argentino, have been placed in liquidation, while a further reduction in the number of shareholding banks has been brought about by the recent (1936) fusion of the Anglo-South American Bank with the Bank of London and South America.

At the same time, another register was compiled at the central bank of all the non-shareholding banks (i.e. banks with capitals of less than one million pesos). These banks were required to apply through the central bank for permission to continue their operations. By 31st December, 1935, the central bank had received fifty-five such applications.[1] No new bank has yet applied for permission to begin operations.

Capital and reserve funds

The only obligation on the banks under this heading is that which requires national banks (i.e. native banks) and branches of foreign banks established in the Argentine to apply each year at least 10 per cent. of their liquid profits to a reserve fund until this fund reaches at least 50 per cent. of their paid-up capital and until the capital and reserves together represent 33 per cent. of the savings deposits. A regulatory decree[2] enacted that a start was to be made in the constitution of a reserve fund by the allocation to this purpose of 10 per cent. of the net profits made in the first financial year.

[1] First Report of the Banco Central de la Republica Argentina.
[2] 8th August, 1935.

Contrary to the recommendation of Sir Otto Niemeyer that banks should have a minimum paid-up capital of one million pesos, the Banking Law lays down no minimum capital requirements. In the official commentary it is stated that this restriction on the size of banks would not be beneficial in the Argentine, since small local banks with a paid-up capital of much less than one million pesos might perform very valuable services.

Cash balances

One of the most important provisions of the Banking Law is the obligation to maintain minimum ratios of cash to deposits. This practice, although open to criticism on the well-known grounds of inelasticity, may perhaps be justified in the case of a country in which no convention exists, as in England, as to the proportion of cash to deposits to be held by the commercial banks.

The law requires that all national banks and branches of foreign banks established in the Argentine shall keep a cash balance equal to at least 16 per cent. of their sight deposits and 8 per cent. of their time deposits. That these proportions were reasonable in the existing (1935) conditions of Argentine banking is suggested by the following figures. In March, 1931, when the cash reserves of all the banks in Buenos Aires and their branches were at the lowest level reached during the years of depression, the legal minimum ratios would have called for cash holdings of 10·5 per cent. of total deposits equivalent to 422 million pesos; the actual cash reserves held were 433 million pesos. Similarly, in August, 1934, the statutory cash reserves would have amounted to 10·8 per cent., equivalent to 394 million pesos; the actual cash reserves totalled 443 million pesos.[1]

It should be noted that the Niemeyer Report suggested minimum proportions of 20 per cent. of sight deposits and 10 per cent. of time deposits. These, however, were justifiably rejected as being too exacting.

[1] Official Commentary on the Laws.

All banks with a capital of one million pesos or more must, according to the law, keep at least two-thirds of the requisite cash reserves in the form of sight deposits at the central bank ; the balance may be held in notes or coin. The regulatory decree, however, slightly modifies this requirement by stating that such banks must keep at least two-thirds of their cash reserves either with the central bank, if domiciled in Buenos Aires, or with the branches of the Banco de la Nacion, if in the country ; the remaining one-third may be held either in notes or coin or in deposits with either of these institutions.

In the event of the cash holdings of any bank (calculated on average cash balances as at the close of business daily) falling below the legal minimum, that bank, subject to the exercise of the discretionary powers granted to the central bank, must make up the difference immediately. The Banco Central has the power to exempt any bank temporarily from the observance of these minimum provisions, up to a maximum period of two years. During this period the delinquent bank is forbidden to distribute profits without its authorisation, the object being, of course, to enable the bank in question to reconstitute its cash reserves as quickly as possible. After the lapse of two years the bank must either comply immediately with the provisions of the law or submit to the central bank a plan in which it proposes to comply within a stipulated period. If the bank is unable to submit a plan, or if the plan submitted proves unsatisfactory, then the bank is to be placed in liquidation.

A special department has been set up in the Banco Central to collect information about the daily cash balances of the banks, and to see that they observe the reserve requirements of the law.

Finally, it should be noted that the government were aware of the difficulties which some banks might experience at the outset in complying with the reserve requirements, and therefore made it possible for them to obtain the necessary cash reserves by having recourse to the

Instituto Movilizador. The work of this liquidation institute, already briefly described, will be dealt with more fully in another section.

Investment operations

Following the recommendations of Sir Otto Niemeyer, the government has refrained from embodying detailed regulations in the banking laws as to the investments permitted to a commercial bank. It was suggested in the Commentary on the Laws that, in time of economic or financial crisis, the existence of a mass of detailed regulations would be a hindrance rather than a help. For this reason the provisions contained in the Banking Law, while restricting banks from investing in certain long-term securities, do not require them to adopt any positive investment policy. The successful functioning of the banking system is therefore really left, in the first place, to the discretion of the management of the banks themselves, and, secondly, to the controlling influence of the central bank.

The general object of the legislation is to make the immobilisation of deposits in real estate, shares and debentures, and direct or indirect participation in industrial companies, impossible beyond certain limits. Such a prohibition on long-term investment is very desirable in a country such as the Argentine, where the banks, unless compelled, would be less inclined to invest in liquid assets than is perhaps the case in a country with a well-organised money market offering opportunities for safe and remunerative short-term investment.

The amount of real estate that may be held by a bank is restricted by law. Any bank may hold property for its own use not exceeding in value 20 per cent. of its capital and 50 per cent. of its reserves; any property held in excess of this value must be amortised gradually, according to a plan to be submitted to the central bank. A similar procedure of amortisation and liquidation was required to be followed in respect of all holdings of pro-

perty, not intended for the use of the bank, as at the date at which the law came into force (31st May, 1935). Any property acquired in payment of debts must be sold within four years, in accordance with a scheme of liquidation submitted to the central bank. An extension of time may, however, be granted by the central bank in the last case, the maximum period being, in all, six years.

Limitations are also imposed on the total value of shares and debentures that may be held and the period for which they may remain in a bank's portfolio. No bank may hold for a period longer than two years after their purchase the shares or debentures of any company to an amount exceeding 20 per cent. of the capital of the company or 10 per cent. of its own capital and 25 per cent. of its reserves. Holdings of securities above the limit fixed as on 31st May, 1935, were to be disposed of gradually over a period of three years, according to a plan to be submitted to the central bank; similarly, shares or debentures acquired by a bank in payment of debts, etc., and in excess of the limits mentioned above, were also to be liquidated within three years, although the central bank was authorised to extend the period by a further year. The framers of the law were at pains to enable the banks to continue with their traditional business of underwriting loans. Hence, a certain amount of latitude was allowed to the banks, in so far as only a gradual liquidation over a comparatively lengthy period was required.

All banks are prohibited from participating directly or indirectly in commercial, agricultural or industrial enterprises of any description whatsoever. This provision is directed against the danger of banks becoming too intimately connected with a non-banking enterprise. No bank may undertake the administration of the properties of its bad debtors for a period in excess of two years, although this period may be extended by the central bank. Finally, the law prohibits banks from accepting the shares and bonds of other banks as security for loans to such banks. The official commentary explains that the purpose

of the prohibition is " to prevent banks from giving each other assistance in a surreptitious manner, as in the case of one bank granting credit for the purpose of the purchase of the shares or bonds of another ". Similar provisions are found in other banking laws.

Deposits and interest

Special attention has been paid to the question of the interest to be paid on deposits and to the distinction between sight deposits and time deposits. The interest paid on sight deposits must be at least three points less than the minimum rediscount rate of the Banco Central; on savings deposits the interest must be at least one point less than the rediscount rate. Thus, when the Banco Central de la Republica Argentina fixed its minimum rediscount rate of 3·5 per cent., on 5th February, 1936, the maximum rate payable on sight deposits was 0·5 per cent. and the rate payable on savings deposits was 2·5 per cent.

The introduction of this traditional English principle of the dependence of interest rates on bank rate is no doubt due to Sir Otto Niemeyer's influence. It is a provision which makes for flexibility and should prove of great benefit, both from the point of view of the individual banks (see below) and from the broader aspect of central-bank control.

Definitions of the various types of accounts are given in the law as follows: sight deposits include all liabilities payable within thirty days or subject to less than thirty days' notice before payment; time deposits comprise all liabilities, including savings deposits, payable after thirty days or subject to not less than thirty days' notice before payment.

The reasons given in the commentary for the adoption of this limitation of interest rates are interesting. By fixing a relatively low level of maximum rates it was hoped that, in the first place, the danger of excessive competition on the part of the banks to secure deposits bearing high rates of interest would be obviated and, secondly, that the banks, being no longer under the

necessity of paying uneconomically high rates for deposits, would not be tempted to the same extent to make risky, if remunerative, investments. Both these reasons are sound and the observance of the maximum rates should materially strengthen the fabric of the banking system.

The rigid distinction between sight deposits and savings deposits (including time deposits), according to which no savings deposits can be accepted unless subject to at least thirty days' notice, was framed with the object of preventing banks from competing amongst themselves by offering large customers the high rates of interest payable on long-term deposits, while allowing them, in fact, to use the accounts as drawing accounts.

In addition to drawing this sharp distinction (although it should be observed that the banks themselves are at liberty to make payments from savings accounts at any time), the Banking Law endeavours to restrict the amount of savings deposits accepted. The section enacts that no interest will be paid to private persons on savings deposits above 20,000 pesos, or to co-operative or mutual benefit societies above the limit of 50,000 pesos. The real purpose, therefore, of these sections is to prevent the banks from accepting too great a volume of time and savings deposits, for the relatively high interest burden of such deposits constitutes a serious drain on profits.

Finally, special protection is given to the small depositor in the event of a bank failure. Savings deposits of up to 5000 pesos are given a preferential claim on general assets after certain other classes of privileged creditors have been satisfied. Co-operative and mutual benefit societies have this right up to an amount of 10,000 pesos. A very close parallel to this system exists in Switzerland.

Inspection and reports

The general control of the commercial banks is given to the Banco Central [1]; " the functions of inspection, control and examination of the banks, including the request for

[1] Central Bank Law.

balances and information which have heretofore been in the charge of the Inspectors of the General Department of Justice, shall be the exclusive faculty of the central bank. . . ."

Every bank in the Argentine must, in accordance with the Banking Law, submit to the central bank, in a prescribed form, monthly reports of its operations and any further information that the central bank may require. The statements must show the position at the close of business in every month, and must reach the central bank within twenty-one days of that date. On the other hand, a regulatory decree relieves the banks of the necessity of supplying the various government departments with statistics and statements. The central bank, in its turn, is required to publish every month a summarised statement of the information received, without, however, disclosing the identity of the individual banks. Each bank, moreover, is compelled to publish a balance sheet and profit-and-loss account, in an approved form and certified by a national public accountant, within sixty days after the close of its financial period.

It should be remembered that, in addition to the information obtained from the monthly reports, the Banco Central has organised a department to keep in touch with variations in the daily cash balances of the banks, and a Credit Department to examine applications for rediscounts and advances. These two departments keep closely in touch with the Inspection Department described below.

The inspection of the commercial banks is entrusted to a special department of the central bank. The inspectors have access to all the books, accounts and documents of every bank, and submit reports direct to the president of the Banco Central, who only informs his board on the subject when he deems it advisable to do so. By this means it is hoped to keep the information as secret as possible, since some of the directors of the central bank may be connected with other banks.

Any transgressions of the Banking Law are to be reported by the inspectors to the legal authorities, who then take steps to impose the relative penalties. The central bank has no powers itself to impose penalties.

A further function entrusted to the Inspection Department is the liquidation of failed banks. The first liquidation under this section was that of the Banco Argentino de Fomento, which closed its doors on 18th July, 1935.

It will be seen that considerable powers have been given to the central bank. The detailed information which it receives of the activities of each bank should prove of the utmost benefit in the framing and carrying into execution of any given monetary policy. Moreover, it should enable the central bank to take steps to counteract any undesirable tendencies in the investment policies of the banks before they have time to endanger the stability of the whole banking system.

Control of credit

The provisions of the Banking Law are made, or are intended to be made, practical realities through the quantitative and qualitative control of credit by the central bank.

Generally speaking, by defining the type of paper that it will rediscount and the terms on which it will grant advances, a central bank is able to determine to some extent the type of investments which the commercial banks will hold. To this passive aspect of credit control must be added the dynamic control by means of changes in the discount and advance rates, and open-market operations. The passive aspect will be considered first.

Rediscounts and advances

The Banco Central is required, by the Central Bank Law, to rediscount the following types of document :—

(a) Bills or promissory notes deriving from *bona fide* commercial transactions, bearing at least two good signatures, one of which must be that of a banking

firm, and maturing within 90 days. If the bills bear three or more good signatures (including at least one of a banking institution) the rate of rediscount is required to be lower than in the preceding case. The regulatory decree governing the central bank fixed the rebate as up to ½ per cent.

(b) Bills or promissory notes deriving from operations relating to the production, processing or sale of agrarian, live-stock or industrial products, bearing two good signatures (one of which must be that of a banking institution) and maturing within 180 days; similar bills bearing three good signatures or more (one of which must be that of a banking institution) are eligible for a rebate.

The Banco Central is also authorised to grant advances to *shareholding* banks for a maximum period of ninety days, at a minimum rate of interest of at least one per cent. above its official rediscount rate for ninety days' sight documents, against the following instruments :—

(a) Bills of exchange and promissory notes up to 80 per cent. of their nominal value.
(b) Securities of the Federal Government up to 80 per cent. of their market value and not exceeding a specified total amount.

The general object of these provisions is to enable banks carrying on *bona fide* commercial transactions to obtain ample accommodation at the central bank. To safeguard the interests of the central bank (and ultimately, also, those of the commercial banks) a Rediscount Committee has been appointed (11th January, 1936) which is to scrutinise all bills submitted for rediscount or as collateral for loans, and, in addition, is to consider whether the proceeds will be employed in consonance with the policy of the central bank. To this end, a special Credit Department has been established.

Open-market operations

The framers of the Banking Laws realised that situations might arise in which the normal methods of control—the raising of the rediscount rate and advance rate—might be of little use. Hence, the central bank is given powers to buy from or sell to commercial banks Consolidated Treasury Bonds up to a total amount of 400 million pesos. These bonds were created out of the conversion of the balance of the old Patriotic Loan Bonds and of the Treasury Bills held as security for advances to banks by the Banco de la Nacion; they bear interest at 3 per cent.

These powers were soon utilised by the Banco Central to take up from the money market some of the surplus funds which the banks had received as a result of the distribution of the profit arising from the revaluation of the gold stocks of the Caja de Conversion. This accretion of reserves to the banking system amounted roughly to 314 million pesos. In June, 1935, the central bank decided to offer to the shareholding banks certificates of participation in Consolidated Treasury Bonds up to a nominal amount of 250 million pesos; these certificates were rediscountable and bore interest. In January, 1936, a system of tendering was adopted, the certificates being allocated to the highest bidder. Rediscount was again provided for in case of need at the central bank's minimum rate of discount for ninety days' paper bearing three signatures. These operations relieved the market of much of its superfluous funds and materially reduced any likelihood of credit inflation taking place. No doubt the central bank will buy securities from the banks, if they become hard pressed for cash.

Instituto Movilizador

No account of the banking reorganisation or of the control of the commercial banks would be complete without some description of the aim and activities of the liquidating institute set up by Law No. 12,157. Created

with the object of taking over the frozen assets of the commercial banks and realising them gradually over a period of years, the Instituto Movilizador, with its capital of 10 million pesos and reserves of 380 million pesos, has already undertaken a major reorganisation of four large banks, and relieved the Banco de la Nacion Argentina of the credits granted by it to the commercial banks at various times before the central bank came into existence. These operations required an expenditure of 368·41 million pesos, so that only a relatively small amount of liquid funds now remains for further operations.

Apparently no further intervention by the institute is contemplated, as the authorities issued a statement at the beginning of 1936, to the effect that the reorganisation of the commercial banks was regarded as complete.

Conclusion

From a general point of view perhaps the most interesting feature of the Argentine banking laws is the concentration of control in the hands of the central bank. The Argentine is the only country considered in this book (Great Britain apart) in which the work of supervision has not been given either to a government department or to an independent commission or commissioner. The reason for this lies, perhaps, in the fact that this is the only banking code based on the proposals of an English banking expert. The merit of the arrangement is: (a) that divided responsibility, which is a potential weakness in other systems of control, is avoided; (b) that there is no unnecessary duplication in such matters as the making of returns; (c) that no attempt is made to draw what is often a very hypothetical distinction between qualitative and quantitative control; and (d) that (it has been claimed) the central bank will operate more flexibly than would a bureaucratic commission.

The second main feature of banking regulation in the Argentine is its simplicity. Here, again, it is clear that, unlike certain other South American banking laws, the

Argentine law is built up on British rather than American banking traditions. The central bank is in part owned by the commercial banks; there is a statutory cash ratio; interest payable on deposits is related by law to the official rediscount rate; limitations exist on the holding of real estate and securities; and there are restrictions on participation in businesses not akin to banking; but here similarity to the law of the United States stops. There are no minimum capital requirements; no restrictions on loans to a single customer or on underwriting new issues; no detailed control of the management or the directorate of the banks; little regulation of security for loans; no prohibition of loans to officers; no licensing system for the opening of branches; no double liability provisions. A premium is put on good internal management coupled with guidance from the central bank.

It is still too early to say how successful the experiment will be, for no major economic disturbances have taken place since the regulation was introduced. But, given the right spirit of co-operation between the commercial banks and the Banco Central, there is no reason why the reconstituted banking system should not operate successfully and vindicate the aspirations of those responsible for it.

BELGIUM

BELGIUM

" *Mixed* " *character of Belgian banking*

Belgium can lay claim to being both the earliest European country to develop a commercial banking system, and the one in which the " mixed " system of banking originated and found its most highly developed form. The Société Générale pour Favoriser l'Industrie Nationale was founded in 1822, and still survives, under the name of the Société Générale de Belgique, as the oldest commercial bank on the Continent and the most important in its own country. Three other fairly large banks were founded within the next twenty years, and all four had wide powers, including the right of note issue until the foundation of the National Bank in 1850. These wide powers, the lack of capital for the growing needs of industry, and the favourable features of Belgian law, were the principal bases for the development in Belgium of the " mixed " system of banking, under which financial institutions conducted short-term deposit banking and at the same time long-term industrial financing. The banks, particularly the Société Générale, became a recognised source of new capital for the foundation of new enterprises, often taking the initiative in their creation, and for the development of existing undertakings. In return for providing them with capital on long-term the banks obtained varying degrees of control over industrial undertakings, either by holding large blocks of capital or by being represented on the boards of directors. Though the Belgian banks were conducting deposit banking, industrial financing was for long their main source of profit.

The principles on which the Belgian banking system has

been built up are in strong contradiction to those followed in this country, but there is in fact no strict comparison. The capital of Belgian banks has always been large in comparison with that of pure deposit banks, such as the English. Moreover, they have rediscounting facilities available to them at the central bank, and though in the past they have not availed themselves of them to any large extent, their existence has acted as a reserve available in times of stringency or crisis.

Development of the banking system

The Belgian banking system as it existed immediately before the War was one lacking both in centralisation and co-ordination. At the head of the commercial banks was the Société Générale, which had its main business in Brussels and worked in close conjunction with a number of affiliated banks in important centres in the provinces. Then there were a few medium-sized banks, operating chiefly in Brussels, and a large number of smaller institutions working quite independently, chiefly in industrial centres throughout the country. The total number of joint stock banks was about seventy, with nearly three hundred subsidiary offices, of which all except fourteen were situated in Belgium.

The changes brought about by the War served to increase the investment side of the banks' business. The reconstruction and development of Belgian industry in the post-War period was carried out to a large extent by long-term advances and participations on the part of the banks. High price-levels and the world demand for Belgian constructional material resulted in the Belgian banks issuing a stream of new capital, both industrial and colonial, in many of which they retained substantial interests. To enable them to do so, their paid-up capital was substantially increased, both by making calls of capital previously uncalled (the proportion of uncalled to paid-up capital in the most important Belgian banks at the end of 1928 was 13¼ per cent., as compared with 20 per cent. in 1914) and issues

of entirely new capital at substantial premiums. Their *fonds propres*, i.e. capital and reserves, with which their investments were made and on the size of which their stability was largely judged, rose substantially. The movement gained considerable force in the period 1927–30, during which the combined reserves of a number of representative banks were more than doubled.

From the widely scattered, heterogeneous system of the pre-War years, the banking system has since progressively developed into a well-knit, centralised system. In spite of an increase in the number of banks, the tendency since 1920 has been towards amalgamation and co-ordination. The large Brussels banks have absorbed many of the smaller institutions, and there has developed a system controlled from one financial centre. When the world depression struck Belgium, there were two main groups of banks, the Société Générale and the Banque de Bruxelles, which with their affiliates were represented in about 450 centres of population throughout the country, and held well over one-half of the assets of all commercial banks. There was also a rapid expansion of branch banking, the total number of offices of the 125 commercial banks having risen to 1255 in 1936, of which 50 were outside Belgium (32 in the Congo); 958 of the offices belonged to the four biggest banks.

Lack of control

Until 1934 the only control over Belgian banks was that imposed by the general company law. Their activities were under no special restrictions and almost their only obligation was that, in common with other companies, they were required to submit to shareholders before the annual meeting a balance sheet, a profit-and-loss account and an auditors' report. There was no prescribed form for any of these published statements, and they varied widely from bank to bank. Shareholders also had the right to obtain from the head offices of the banks particulars of all securities held. In practice, most of the

banks published a list of their securities as a supplement to their report. Only two banks regularly issued monthly statements of their position. There were no restrictions whatever on the establishment of new banks, and anybody might set up a new bank as long as he respected the ordinary laws regarding commercial undertakings. The National Bank had no statutory control over the banking system, but through its discount policy it exerted a large measure of control over interest rates, and, it is said, exercised, through its rediscounting facilities, some general kind of supervision.[1]

The depression and subsequent developments, however, have ushered in a far-reaching system of reform, and from one of the freest and least restricted of commercial banking systems, the Belgian has changed into one where control is both wide and complete.

The depression and first measures of reform

As a whole, the Belgian banking system has been relatively free from trouble. With the intensification of the general depression after 1930, however, the banks were particularly affected, owing to their close relations with industry. Many, mostly among the new banks, found themselves in a serious position owing to the reduced returns obtainable from their industrial investments and the sharp depreciation in the capital value of a large part of their assets. There were, however, few failures. Among the most important was that of the Banque du Travail. The deposits of the bank at the time of its failure in April, 1934, amounted to 300 million francs, but in preceding weeks they had declined substantially owing to rumours regarding its solvency. Its collapse was attributed to its close association with industrial undertakings, chiefly in the textile industry, which were severely affected by the crisis. About one-half of the bank's deposits were those of various co-operative societies, and its failure created a deep impression throughout Belgium.

[1] Parker Willis and Beckhart, *Foreign Banking Systems.*

Other banks drew extensively on their reserves, both disclosed and hidden, and large capital reductions were made. With the maintenance of the gold standard by Belgium, however, the banks' difficulties were increased by the rigours of a strong deflationary policy, and a gradual loss of confidence in the currency. The result was seen in a continuous drain of deposits for conversion into gold or for expatriation. Credits became frozen, and the banks would grant new advances only at high rates of interest. Accordingly, a decree of August, 1934, introduced measures designed both to restore liquidity to the banks and to make cheaper credit available to industry. Devaluation was not yet accepted as a remedy for relieving at the same time the currency and the banking difficulties.

In the official pronouncement of the reforms it was pointed out that the banks had in general withstood the crisis well, but that under their existing organisation they had been prevented from fully exercising their rôle in the national economy. The solution was to be sought in the abandonment of the " mixed " system of banking. This step was partly a reaction from the excesses of the post-War boom period, and partly the effect of the shock to public confidence occasioned by bank failures, and the enforced reductions in reserves and capital by other banks. A further cause was widespread criticism in parliament and the press of the powerful influence which the big banks were acquiring in industry. The Société Générale was said to control a third of the Belgian coal output and one-half of the industry of the Belgian Congo. Only a few weeks before the reforms the president of the Antwerp Chamber of Commerce had severely criticised the banks' control over the coal-mining industry. M. Franck, governor of the National Bank, is reported to have said that in times of prosperity finance had gained an influence over industry which in times of crisis constituted an undue mortgage of industry to the banks.

There was little doubt that the big banks had kept to their self-imposed policy of investing in industry only up

to the limit set by the supply of their own funds, as distinct from deposits, but it was known that in some other banks deposits themselves had been invested in long-term industrial financing. Official opinion took the view that owing to the risks inherent in the "mixed" system, a pure deposit banking system on English lines was to be preferred. Speaking of the proposed separation of industrial and deposit banking, M. Franck said in August, 1934 :—"It is a fundamental distinction which is traditionally followed in England by the great London and provincial banks ; generally in France and Holland ; and recently made compulsory in the United States". Apparently it was thought desirable that Belgium also should fall into line.

In the official pronouncement the justification for this reversal of a banking tradition built up over more than a century was that separation of the two sides of the bankers' business would enable the position of individual banks to be clearly seen, a thing which, it was said, was not possible under the existing system. Accordingly, as from 1st January, 1936, it was forbidden to all deposit banks, i.e. "those whose business it is to accept funds at interest payable within two years", to take shares or participations in any industrial or commercial undertaking, and those holding industrial shares were to give them up before that date. At the same time financial institutions creating and controlling industrial enterprises were forbidden to accept deposits. Before the appointed day each of the existing banks was to renounce one or other of these activities, or to divide itself into two distinct units. Deposit banks were, however, allowed to hold the shares of other deposit banks, under certain conditions, and Belgian Government and other public securities. They were also allowed to deal in securities which came to them for short periods in the course of their ordinary banking business. The minimum capital of each deposit bank was to be 10 million francs, but subsequently, to meet the case of a number of small banks, it was provided

that for existing banks a minimum paid-up capital of one million francs would be sufficient. As from 30th June, 1935, they were to publish monthly statements of their assets and liabilities in prescribed form. The new measures were not to apply to the National Bank nor to the various public credit institutions and co-operative societies.

Société Nationale de Crédit à l'Industrie

To give more immediate results the government sought to provide cheaper credit for industry. In its report on the subject it stated : " The economic recovery of Belgium is only possible by a return to abundant and cheap credit. On the one hand, short-term advances have, by force of circumstances, become immobilised : on the other, the care of their liquidity has compelled the banks to adopt a policy of restricted credit liable to harm business. The situation cannot last without resulting in a progressive paralysis of our activity." Cheaper credit to industry was to be provided by an extension of the activities of a semi-official institution, the Société Nationale de Crédit à l'Industrie. This was a body set up in 1919 to grant medium-term credits to industry, usually of five years. It was now provided that with the help of the government this institution was to take over from the banks credits considered to be sound but not likely to be liquidated for some time. In return for their transfer, the banks were to receive bonds guaranteed by the state, against which they could secure loans at the National Bank up to 80 per cent. of their face value. Though it was not expected that the banks would borrow from the central institution on any large scale, the fact that the facilities for obtaining liquid funds were available was expected to increase confidence. The government's contribution to the scheme consisted chiefly of giving its guarantee to 2000 million francs of bonds to be issued by the Société for transfer to the banks. The bonds carry interest at 3 per cent., but the Société was to charge 4½ per cent. on the frozen

credits which it took over from the banks, the difference providing a margin to cover expenses and possible loss. The banks remained responsible for the payment of interest on the frozen credits and for their eventual repayment. The bonds are repayable after twenty years, and by that time it is estimated that a large sum will be available in the sinking fund which is to be built up from the difference between the borrowing and lending rates of the Société. Moreover, a large part of the frozen funds are likely by that time to have been liquidated. The immediate effect of the new measures was to reduce the cost of bank credit to those borrowers whose credits were taken over by the Société Nationale—most of them had been paying 6 to 7 per cent. interest—and also to increase the available funds in the hands of the banks. It was thereby hoped that the banks would be able to grant additional accommodation at lower rates than those previously ruling.

The devaluation

The immediate effect of these two measures was disappointing. In fact there was little improvement in the financial position, which had its roots elsewhere than in the internal mechanism of the banking system. The separation of the banks into deposit and investment institutions could not have been expected to have any immediate results, and the cheapening of the cost of credit through the operations of the Société Nationale de Crédit à l'Industrie was overshadowed by an intensification of the loss of confidence in the currency. During the latter part of 1934 and the beginning of 1935 capital continued to be expatriated, the deposits of the banks accordingly fell, and they were even less inclined than formerly to grant new credits.

The situation of the Boerenbond Belge, which controlled a large volume of savings accounts, aroused further public alarm, and the government formed the Office Central de la Petite Épargne to exercise some degree of

control over the affairs of the large number of financial institutions specialising in small savings. At the beginning of the year the important Algemeen Bankvereeniging had to be reorganised.

The strain reached breaking point in March, 1935. The banking and financial system had reached a position of great illiquidity and stringency, but the causes were not to be found in the banking system itself. They were, in fact, little more than reflections of an overvalued belga and the deflationary efforts made to maintain it. In March there was a renewed outward flow of capital, and a strong speculative drive against the belga, coupled with an internal political crisis. For a short time an exchange control system was imposed through the National Bank. The probability of a general closing of the banks was prevented only by the government guaranteeing further extensions of credit to the banks, eventually to the extent of 6 million francs. The new government, in its declaration of policy, announced that if it became necessary it would go so far as to guarantee bank deposits. On 31st March, the belga was formally devalued by 28 per cent. There was an immediate repatriation of Belgian capital and even an influx of foreign capital owing to the continued uncertainty surrounding the remaining countries of the gold bloc. The position of the Belgian banks was immediately relieved, and any guarantee of bank deposits by the government became unnecessary.

The institution of control

In the declaration of policy which M. van Zeeland made on taking office as Prime Minister in March, 1935, he stated that he intended to introduce further measures to control the banking system. The main feature of the reform was to be a legal statute for the banks, comprising regulations affecting capital, the proportion to be kept between capital and the different items of assets and liabilities, and the employment of funds in the hands

of the banks. Supervisors would be appointed to ensure that the regulations were duly carried out, and an institute, which might be the National Bank or a body sponsored by it, would supervise general credit policy.

This promise was fulfilled by a decree issued on 9th July, 1935, by which time the position of the banks had become considerably easier under the beneficial influence of the devaluation and the accompanying return of confidence. The new law, promulgated in the form of a decree by virtue of the special powers conferred on the van Zeeland Government, primarily established a reform of the banking system, but also introduced new regulations in other sections of the Belgian financial and credit system. Its provisions came into force on 1st September, 1935. The reforms introduced in the previous year were absorbed in a comprehensive scheme of reorganisation. In the meantime the separation of deposit and investment banking had made some progress, the Société Générale de Belgique, for example, having already formed an associated institution, the Banque de la Société Générale, and the Banque de Bruxelles the Société de Bruxelles pour la Finance et l'Industrie.

The preamble to the new law stressed the urgent necessity of some measure of control over deposit banking. It was pointed out that since the War the importance of commercial banks to the monetary system had been increasing, owing largely to the replacement of bills of exchange by open account dealings as a means of settling payments. It was declared that owing to the rapid growth of this form of payment and of the number of cheques, the commercial banks had in effect become banks of issue, responsible for a large part of the monetary circulation, and their control had accordingly become a matter of as great importance to the national credit as the control of the central bank itself. The main provisions of the decree are given in the following paragraphs.

General scope

With specific exceptions, the regulations apply to " all undertakings, Belgian and foreign, which regularly receive deposits payable at sight or within two years, with the object of using them, on their own account, in banking, credit or investment business ". There are thus included in the scope of the regulations not only banks formed as limited companies, but private bankers, in so far as they conduct deposit banking business, and, so far as is practicable, the Belgian branches of foreign banks. (Foreign banks operating in Belgium must keep at the chief of their Belgian offices a separate accounting record of the bank's transactions in the country.) The specified exceptions are the National Bank, various official and semi-official institutions such as the Société Nationale de Crédit à l'Industrie and the Institut de Réescompte et de Garantie, financial undertakings which receive funds from affiliates solely for investment purposes, and other institutions purely of a savings bank nature.

Registration with the Banking Commission

All institutions falling within the scope of this law are required to be registered with a Banking Commission, set up under the terms of the decree. Existing institutions were required to register within a month from 1st September, 1935. Only institutions registered with the Commission are allowed to use the word " bank " or " banker " in their name. All amalgamations between banks must, under penalty of being made entirely void, be authorised by the Commission. A bank may no longer be constituted in the form of a " credit union " or a co-operative society.

Nothing is said in the decree about the refusal of applications for registration, the apparent intention being that the Commission shall exclude unsuitable institutions from the business of banking. Persons with bad business records and reputations are expressly forbidden to become

directors or other administrative officials of banks.

The Commission is to publish an annual list of registered institutions, and appeal against omissions from the list may be made to the Minister of Finance. The first list of registered institutions was published at the beginning of 1936. The total number of undertakings registered was 125, including the Belgian offices of a number of foreign banks.

Capital

The capital of banks must be fully paid up, and amount to at least 10 million francs for banks formed as public companies and 2 millions for private banks, i.e. those belonging to individuals or constituted as partnerships. These regulations apply specifically to the foundation of new institutions ; banks in existence in October, 1934, need have a minimum paid-up capital of only one million. These details were the same as under the existing regulations. Foreign banks in Belgium must earmark for their business in the country at least ten million francs.

Reserves

Reserves must be invested in securities of the gilt-edged type—government, colonial, municipal, or bearing the guarantee of such bodies. Reserves must be shown separately in balance sheets, and may appear there at their purchase price, provided that it is not greater than their value at maturity or redemption.

Liquidity

In its report to the King, which accompanies the decree and may be regarded as its official explanation, the government emphasises that it regards the fixing of minimum proportions between the chief assets and liabilities as a matter of the utmost importance. It recognises that elasticity is required, and lays down no rigid rules. The determination of ratios is left to the Commission, which is

given power to fix two proportions to be observed by the banks :—

(a) between liquid assets on the one hand, and sight and short-term liabilities on the other, and
(b) between capital and reserves on the one hand, and the total amount of deposits and other sight and short-term liabilities on the other.

No specific proportions have yet been fixed by the Commission, the banks still being in a sufficiently liquid or over-liquid condition.

Periodical returns

Banks must forward to the National Bank an annual balance sheet and a monthly statement of their assets and liabilities, both in forms prescribed by the Commission. On the basis of these returns the National Bank is required to publish, at least every quarter, a statement showing the position of the banking system as a whole. Under the regulations imposed a year previously, banks themselves were required to publish monthly statements of their position. This is apparently the only point on which the new law relaxes requirements imposed by the old.

Securities

A deposit bank may not hold any shares, debentures or participations except

(a) those of affiliated institutions or other banks,
(b) securities issued by the bank, which may be held only up to six months from the date of issue, and
(c) securities held against doubtful or " frozen " debts ; these may be held for two years.

Banks which at the time of the decree held any industrial shares or participations were required, before 1st January, 1936, to dispose of them or to divide into two distinct undertakings. Special provisions were made for the transfer of holdings to the new companies to be made

without undue expense, and for the capital of the new undertakings to be issued gradually. The separation of deposit banking and industrial financing, introduced a year earlier, was thus confirmed.

It appears from the first annual report of the Banking Commission that the separation of industrial and financial from deposit banking had not completely taken place by the end of 1936. What has happened in most cases is that the old mixed bank has founded a new deposit bank, provided it with capital and transferred to it its deposit liabilities and a corresponding part of its assets. The old bank has retained its participations which in several cases have exceeded its *fonds propres.* In such cases it has only been possible to make the assets and liabilities of each balance by the new bank advancing substantial credits to the old (i.e. the financial company). There is, in such circumstances, a double relationship between the two banks. The capital of the deposit bank belongs to the financial company, and the financial company has become a debtor of the deposit bank, sometimes to an important extent. This was inevitable to start with, but if it continues the whole purpose of the law is frustrated. Mixed banking is merely displaced by the American affiliate system. The report of the Commission goes on to state that the Commission has made every effort to secure that the spirit as well as the letter of the law shall be observed. In particular, it is making sure that the management of the deposit banks is completely independent of the financial companies; that credits advanced to these companies by the banks are sufficiently secure and liquid; and that abnormal circumstances in such relationships are immediately subjected to examination. In some cases financial companies have been requested to dispose of securities in order to repay credits to the banks.

The Commission cannot, of course, keep a close watch on all these relationships; that is the task of the auditors of the individual banks (see p. 97).

Influencing public opinion

Banks are forbidden to use their means either directly or indirectly with the object of influencing public opinion. This section is evidently intended to curb the banks' interests and influence in the newspaper world. They are not, however, prevented from inserting ordinary advertisements in papers and periodicals, though they must keep special detailed accounts of all their expenses in this direction, forwarding full particulars to the National Bank with their monthly statements. The Banking Commission may obtain these particulars from the National Bank.

One of the chief objects of the control of publicity is to prevent the public being misinformed with regard to securities issued by the banks. The Commission, in its first annual report, stated that its powers in this connection could only be of limited practical use. There are many ways of influencing public opinion which the act does not restrict, and the report suggested that further legislation might perhaps become desirable.

Directors

A director or other administrative officer of a bank may not take an active part in directing an industrial or commercial enterprise other than a bank, insurance company or mortgage company. As an exception to this general rule, a bank director may be a director of one other non-financial company, or two if he does not take an active part in the running of the bank. In no circumstances, however, may he actively participate in the administration of more than one of the institutions. In special circumstances the Banking Commission may authorise exceptions to these rules. No bank director or other administrative officer may hold any administrative position in an institution created by special law, other than the Institut de Réescompte et de Garantie. No bank may make loans in any form to its directors. In particular, no director may without

adequate security, participate in underwriting a public issue made by the bank.

The Banking Commission, however, may under special circumstances authorise exceptions to the regulations regarding loans to directors, though even then loans must be liquid and paid off within six months.

Where a bank fails or is placed under control (amounting almost to failure), payments made within the preceding two years to directors, as shares in profits, are nullified, and may be recovered. This provision does not operate if the failure has been caused by *force majeure.*

The Banking Commission

A Banking Commission consisting of a president and six other members is set up to ensure that the provisions of the decree are carried out. The members are chosen jointly by the Ministers of Justice, Finance and Economic Affairs, and may be dismissed by them. Two must be taken from a list compiled by the representatives of banks registered with the Commission, and two from a list compiled by the National Bank and the Institut de Réescompte et de Garantie. The president and the two remaining members are the direct nominees of the government. None of the members of the Commission may be a director or other official of a bank. Their period of office is six years. Two members of the Commission, other than the president, retire every other year, the particular members to retire in the first two periods being decided by lot. The place of a deceased or retired member is filled in the same way as he was elected, according as to whether he was chosen from one of the two lists or was a direct nominee of the government.

The general functions of the Commission are to ensure that the new regulations are carried out, and in addition to its powers to fix minimum ratios between certain assets and liabilities, it is specifically charged with the following duties :—

(a) To fix maximum rates of interest applicable to

certain credit operations. Any action by the Commission in this direction must receive the consent of a two-thirds majority, and be approved by the National Bank and the Ministers of Finance and Economic Affairs.

(b) To supervise the activities of the *reviseurs* or auditors of banks (see below), and to charge them to submit reports. The Commission may not call for reports on the relations between a bank and particular customers, except when there has been a violation of the law or when a customer is in a state of bankruptcy.

(c) To instruct the National Bank to make investigations where a bank appears to be violating the provisions of the law, or where the business of the bank is being conducted in such a manner that its liquidity is endangered, or where the auditors do not appear to be adequately fulfilling their functions.

Members of the Commission must not divulge any information gained by them in the course of their duties. Their remuneration is fixed by law, and the expenses of the Commission are, under an agreement with the state, paid in the first instance by the National Bank. The Commission is required to publish an annual report on its activities.

Auditors

Duly appointed *reviseurs* or auditors are the immediate agents through whom the new regulations are carried out. It is provided that the work formerly undertaken by the *commissaires* of banks shall be performed by one or more sworn *reviseurs*, appointed by the banks themselves with the approval of the Banking Commission and Ministers. Their functions are to act as special auditors with a watching brief to ensure that the law is carried out. If they observe any irregularity in the operation of a bank they must report it in the first instance to its managers or directors; if further steps are necessary, they must report the matter to the Banking Commission, at the same time vetoing the irregular action and thereby

delaying it for eight days. They are not required to report on irregularity in respect of taxes. The *reviseurs*, in short, are quasi-government inspectors as well as auditors.

The auditors are not allowed to exercise any other functions in their banks, nor, without the authority of the Banking Commission, to occupy any other remunerated public position or to take part in the running of any commercial enterprise. They may, however, occupy the position of auditor in more than one bank. A bank may not make loans to its auditors or allow them to underwrite any public issue made by the bank.

Except when obliged by law, the auditors may not divulge any information gained by them in the course of their duties. Their remuneration is fixed by the general body of shareholders of the bank, with the approval of the Banking Commission, and they are not allowed to receive any other funds. The first report of the Banking Commission states that in certain cases the Commission has intervened to raise the remuneration of auditors.

Foreign banks operating in Belgium are not exempted from the necessity of appointing *reviseurs*.

Control of the capital market

The foregoing are the provisions of the decree regarding the control of normal banking business. A long section imposes new regulations on the capital market, their effect being to place the entire capital market under the control of the Banking Commission. As the issue of shares constitutes an important part of the functions of most Belgian banks, a brief consideration of these new regulations falls within our province.

No public issues of capital of longer term than five years may be made without the prior consent of the Banking Commission, which must be advised at least fifteen days before the intended date of issue. The body making the issue, whether it is a bank or not, must forward to the Commission, at the time of advising them of the issue, full particulars of the issue and of the

borrower. The particulars must include a detailed list of all obligations of the borrower at home and abroad, the reasons for the issue, underwriting arrangements, and details of what shares and participations are to be retained by the issuers and underwriters.

The Commission examines the issue from two points of view, the state of the capital market and the issue's merits as an investment. If it considers that the issue on the proposed date will unduly disturb the capital market, it can suggest a postponement, a reduction in the amount, or its flotation by instalments. The Commission may suspend the operation for three months if it considers it necessary. If, from the second point of view, the Commission considers that the terms of the issue are likely to mislead investors as to its real value as an investment, it may suspend the issue for three months, though it would not take this step if notification to the issuer and the borrower in itself were sufficient.

The Finance Minister may be recommended by the Commission to forbid the quotation of shares placed on the market contrary to its decisions. In the regulation of the capital market the Commission has no absolute power. Its capacity is advisory only and extends in the main to recommendations and the temporary delay of issues. In fact, however, the possible consequences of ignoring its advice give its decisions the power of law. In all cases the Commission may, as a public warning, make its decisions known.

Belgian undertakings making issues abroad are placed under the same obligations in respect of them as if the issues were made in Belgium.

Issues made on behalf of the state, the provinces and other public bodies are exempt from many of the regulations applying to other issues.

The Commission has not been slow to intervene, and its intervention is said to have been efficacious.[1] It has

[1] Bulletin d'Information et de Documentation de la Banque Nationale de Belgique, 25th January, 1937.

discouraged inappropriate methods of financing, has inquired into the consistency and size of the profits of companies wishing to make new issues, and has required that where shares are issued to the public they should be freely sold to the public rather than taken up by underwriters.

A further form of restriction on the banks in their dealings in securities was imposed by a decree of September, 1935. It was then laid down that only those banks may accept orders for the purchase and sale of securities which are on the Banking Commission's list of registered banks and which have deposited a sum of 300,000 francs as security.

The effects of the reforms

Many of the reforms brought about by the new regulations are radical, and special provisions contained in the decree were designed to facilitate the change-over from the old to the new system. Accordingly some of the new regulations—for example, those affecting directors and the prohibition placed on banks being constituted in the form of credit unions and co-operative societies—were not to come into full force for some little time. The transition from the old to the new system, however, has been effected smoothly.

The working of the Société Nationale de Crédit was disappointing. The maximum amount of frozen advances which it was allowed to take over from other banks was 2 milliard francs. By the end of 1935 the amount taken over was 1·8 milliard francs, a substantial part of which represented advances made to industrial companies associated with the Société Générale, and during the next few months the total declined slightly. Moreover, no reductions in interest charges were made by the banks as a result of its activities. The institute was then freed from the responsibility of granting further credits outside its usual business; its functions, as far as the banks are concerned, being carried on by a new body, the Institut

de Réescompte et de Garantie, set up in June, 1935, to make advances to banks against the security of their ordinary loans. It works in close contact with the National Bank, and obtains resources by issuing bills, both short and long term, for which the state is empowered to give its guarantee up to two million francs.

The wider measures of reform have also in practice not as yet had any appreciable effects. The banking system has undoubtedly attained a greater measure of strength and liquidity by reason of both the separation of the two sides of the banks' business, and the necessity to conform to the new regulations imposed by the law and administered by the Banking Commission. To a large extent, however, the separation has been only formal, and close relationships exist between the *banques de dépôts* and their associated *banques d'affaires*. An important development has been the transfer of the branches of the Société Belge de Banque at Namur and Verviers to the Banque de Bruxelles. The separation of the functions of the Société Belge de Banque, formerly a " mixed " bank, had deprived these two branches of their usefulness, and their transfer to another bank already represented in the locality reveals an important move towards some rationalisation of Belgian banking.

The greatest benefits from the reforms are likely to devolve from the Banking Commission and the auditors. From the auditors the two essential qualities of competence and independence are required, competence being assured by the necessity for their approval by the Commission, and independence being provided for by rules governing their only permissible remuneration. Some possibility of danger arises from the double responsibility of the auditors to the Commission and the banks, but the danger is not considerable. A more significant fact is that the auditors are required to submit reports to the Commission on particular customers only when there has been a violation of the law or the customer is *en état de faillite*. This provides for insolvencies, but gives little protection against

the real danger of credits becoming frozen.

One of the greatest potential forces for good resulting from the reforms is the formation, in the Banking Commission, of an effective instrument for furthering economic policy as well as for carrying out general supervisory functions over the banking system. It is intended that the Commission shall work in close co-operation with the National Bank, and as some of its decisions require the approval of ministers, it is likely to be substantially influenced by the government in office. In addition to its powers over the capital market, it is endowed with at least two other important means of controlling credit :—(a) fixing minimum proportions to be maintained by the banks between liquid assets and short-term liabilities, and also between capital and reserves on the one hand and deposits on the other, and (b) fixing maximum interest rates for specified credit operations. As yet these powers have not been utilised. It has been indicated by the Prime Minister that little control in these directions will be exerted over soundly conducted banks. The smooth and effective working of both the banking system and the credit structure of Belgium, however, depends as much on intelligent interpretation of the underlying principles of the reforms by the Banking Commission, and through them by the auditors, as on the actual form of control laid down by statute.

CANADA

CANADA

Banking in Canada

THE Canadian banking system presents many points of interest to the student of the statutory control of commercial banks. In the first place, it has one characteristic which is to-day unique, though a similar system prevailed in Sweden in the nineteenth century. Since 1871 the charters of Canadian commercial banks have been granted for and renewed at decennial periods; in this way the banking system is regularly and completely overhauled every ten years, and the spasmodic legislation which is so much a feature of banking in most countries is practically unknown in Canada. As a result, the banking code has been progressively adapted to the country's economic requirements. In another direction, however, the control of commercial banking has until recently been severely limited; Canada only acquired a central bank in 1935.[1] Thirdly, the Canadian banking structure has been subject to the interplay of two main influences: English (or rather Scottish) influence, responsible from early times for a widespread branch banking system, followed by a strong amalgamation movement; and American influence, with its close and detailed statutory regulation of banking activities.

Canadian banking institutions, apart from the central bank, may be analysed into a number of classifications:—the ten deposit or "chartered" banks, among which may be distinguished a "big four"; the two-hundred-odd *caisses populaires* (co-operative banks) concerned mainly

[1] The Bank of Canada opened for business on 11th March, 1935.

with loans on mortgages; the one hundred or so investment banks,—"bond houses"; loan, mortgage and trust companies; rural credit institutions similar to the German Raiffeisen banks; and the Quebec, Provincial Government and Dominion Government Savings Banks. Of these only the chartered banks are, properly speaking, commercial banks.

The chartered banks

Prior to 1867 the chartered banks were all, with one exception, constituted under charters granted by one or other of the four provinces of Upper and Lower Canada, Nova Scotia and New Brunswick. The British North America Act of that year, however, vested the control of currency and banking in the newly created federal government, and under the Dominion Bank Act of 1871 the banks, of which there were then twenty-eight, were subjected to a common basis of control, rather on the lines laid down by the National Bank Act in the United States. The various decennial revisions cannot here be described individually, but each has been responsible for some important addition or amendment to this original act of 1871.

The ten chartered banks may in many ways be compared with the English clearing banks. They cover the country with a network of over 3000 branches;[1] are similarly organised; accept both demand and savings deposits, which they employ in making loans and advances, in investment operations, and to a smaller extent in discounting bills and making call loans to investment bankers, stockbrokers and individuals. The financing of imports and exports also plays an important part in their business.

On the other hand, the chartered banks are to be contrasted with the English deposit banks in that they, to some extent, buy and sell investment securities for their own account; underwrite, or participate in syndicates

[1] There were 4676 in 1920, 3431 at the end of 1935, and the number is still falling. Canada has, in the past, been considerably over-banked.

formed to sell, securities to the public (though mainly government and municipal bonds); operate between them about 150 foreign branches,—largely in the West Indies; and issue their own notes. In general, however, their business is deposit banking, as developed and made familiar in this country.

Application of the act

The Bank Act of 1934 applies to the ten existing chartered banks and to any new banks which may be chartered. These banks alone have, since 1880, been authorised to use the title "bank". The act, which remains in force until 1944, forms the actual charter of these banks, and is thus a self-contained banking code.

Some variation of procedure, however, exists as between the ten banks, for the shareholders of each have the right at general meetings to pass by-laws affecting the date of shareholders' meetings, the record to be kept of proxies, the number of directors (minimum 5) and quorum (minimum 3), the qualifications of directors (subject to the act), methods of filling vacancies, the amount of loans to be made to directors, one firm or person, shareholders and companies (subject to the provisions of the act). There are certain other minor matters on which by-laws may be made. A copy of the by-laws is required to be sent to every shareholder every five years.

Incorporation

A special act of parliament is required for the incorporation of a new bank, and such bills are always closely considered by the banking committees of each House. The acts contain particulars of provisional directors, capital and proposed place of business, and subject the bank to the terms of the Bank Act. The form of such special acts is prescribed in a schedule to the Bank Act. The foundation of any new chartered bank is a very unlikely event, for the country is already to some extent over-banked.

Capital

The Bank Act of 1871 required every chartered bank to have a capital of $500,000, and this figure still stands unamended. Up to 1890 only $100,000 was required to be paid up before a bank could commence operations, with a further $100,000 before the end of two years, but as a result of the revision of that year a bank must have $250,000 paid up before it can start business. It must also obtain a certificate from the Treasury Board, and this can be issued only after the paid-up capital has actually been deposited with the Minister of Finance. The minimum capital requirement ruling in Canada is, of course, more severe than those across the border in the United States, but it is not unreasonably high, for unit banking is unknown in Canada and is against the traditions of the country.

Capital stock must be divided into shares of $100 each, and the act contains detailed provisions as to calls, registration and transfer of shares, and other matters which it is not proposed to examine here.

A bank may increase or reduce its capital, provided it has the approval of the Treasury Board and the Board has issued it a certificate. The Board may, however, withhold its approval "if it thinks best so to do". Capital may never be reduced below $250,000 paid up. If any part of a bank's share capital is lost, it must be made good by calls on such subscribed capital as is not paid up and by allocations from net profits. Such losses must be reported to the Minister of Finance in the next return made by the bank.

Reserve fund and dividends

The act lays down no minimum requirements with regard to surplus or reserves. Dividends are, however, limited to 8 per cent. per annum, unless the bank has a reserve fund equal to at least 30 per cent. of paid-up capital.[1] On the 31st December, 1935, four of the ten

[1] Originally 20 per cent.; increased to 30 per cent. in 1891.

banks had reserves greater than paid-up capital, and one of them reserves equal to paid-up capital.[1]

A further section of the act, first inserted in 1871, provides that no dividend or bonus may be declared so as to impair a bank's paid-up capital. Any directors concurring in such declarations become jointly and severally liable for the amount of the dividend or bonus.

Liability of shareholders

The system of the double liability of shareholders has prevailed in Canada since 1871 (and in fact dates back to the incorporation of the Bank of Nova Scotia in 1832), all shareholders being liable not only for amounts not paid up, but also for a further sum equal to the par value of the shares they hold. It is to be noted, however, that, when the act was amended in 1934, it was provided that as the note issues of the chartered banks decline (see p. 113), so the double liability of shareholders will be correspondingly reduced. Provisions for double liability are tending to be repealed in the United States, for it is generally found that the disadvantages of the system outweigh its advantages. There has, however, been surprisingly little default in this connection on the part of bank shareholders in Canada. The figures are available [2] for eight banks which have failed in the present century, and it appears that the capital of these banks amounted to $8,976,000 subscribed and $8,420,979 paid up, while as much as an additional $3,632,323 was paid by shareholders as a result of the double liability provisions,—sufficient in all but three cases to pay depositors back completely. The loss suffered by depositors in these three cases taken together was only slightly over $2 millions. This may be looked upon as a most successful record.

[1] Three years earlier five of them had reserves greater than and four reserves equal to capital. During the depression, however, the reserves of a number of the banks were drawn on.

[2] Report of the Royal Commission on Banking and Currency in Canada, 1933.

Directors and officers

Every chartered bank must have at least five directors. There was formerly a legal maximum of ten, but this was repealed in 1905. Originally all directors had to be natural born or naturalised British subjects living in Canada, but since the 1890 decennial revision it has been sufficient for a majority of them to fulfil this condition. As the Canadian system is a branch banking system, it is natural that directors should not be subject to a residential qualification, as is often the case in the United States, but complaints were made before the Royal Commission in 1933 that too large a proportion of directors were domiciled in the central provinces and that accordingly the attitude of the banks was more sympathetic to central than to eastern and western needs. The Commission felt that there was some truth in this, but they did not see how the suspicion could be allayed by any form of legislation.

The share qualifications of directors vary according to a bank's paid-up capital, as follows :—

> \$3000 paid up, if paid-up capital is \$1 million or less ;
> \$4000 paid up, if paid-up capital is over \$1 million and less than \$3 millions ;
> \$5000 paid up, if paid-up capital is over \$3 millions.

A unique provision was inserted into the law in 1923. Records must now be kept of attendance at directors' meetings and duly brought to the notice of shareholders. It will be seen later that there are provisions in American law designed in part to ensure that directors shall give their whole time to their work. These are probably of little practical use. The Canadian provision, however, seems calculated to secure its object, though some writers profess to be sceptical about it.[1]

It should be added that the report may state the nature and extent of the services rendered by any director

[1] See Parker Willis and Beckhart, *Foreign Banking Systems*, p. 311.

who, by reason of residing at a point remote from the head office of the bank, has been unable to attend directors' meetings.

As is usual elsewhere, a director may not be present at a board meeting or vote when loans to himself or to a concern in which he is a partner or shareholder are under consideration ; but this does not apply to loans to corporations controlled by the bank, the shares of which, except for qualification shares, are owned by the bank. It is an offence punishable by fine or imprisonment for a bank director or officer corruptly to accept gifts as a reward for doing or forbearing to do any act relating to his bank's business, or for showing favour or disfavour to any person. It is equally an offence to offer such gifts. Such actions are obviously not approved by banks in any country, but it is seldom that they are legally prohibited.

Largely as a result of recent American legislation, there were placed before the Royal Commission of 1933 proposals for prohibiting bank directors from acting as directors of other companies. The Commission's Report, however, pointed out that there had been no evidence of discrimination as a result of existing practices, that directors are concerned with general policy rather than day-to-day transactions, and that it is desirable that bank directors should be men engaged in large enterprises and able to bring to the banks both business and a wide knowledge of commercial and financial conditions. The Commission therefore declined to propose legislation.

The law forbids any bank officer to act as agent for an insurance company, or to exercise pressure on any borrower to place insurance for the security of the bank in any particular insurance agency. Banks may, however, reserve the right to approve of the insurance company with which such an insurance is placed. This provision may be compared with that governing national banks in the United States ; national banks may, however, act as agents for insurance companies in places

with a population of under 5000 inhabitants. There are said to have been minor infractions of the law in Canada, but the banks take all possible steps to prevent this.

Finally, there is legislation, as in most countries, concerning loans to officers. The chartered banks may not make loans in excess of, in the aggregate, $1000 each to, or on security given by, any of their officers, without the approval of the directors. Even where the approval of the directors is gained, such loans may not exceed in the case of any one officer an aggregate of $10,000. This last provision was added in 1932. Nor, without the approval of two-thirds of its directors, may a bank make loans in excess of 5 per cent. of its paid-up capital to any director or to any concern in which the president, general manager or a director of the bank is a partner or shareholder. These provisions call for no comment.

Cash reserves

Up to the establishment of the Bank of Canada in 1935 the only requirement as to cash reserves was that 40 per cent. of a chartered bank's reserves should be in the form of Dominion of Canada notes (although the requirement of cash reserves equal to 10 per cent. of liabilities was advocated by the Minister of Finance as early as 1888). It was the custom to hold the balance in the form of gold and subsidiary coin, United States and other foreign currencies, notes of other chartered banks, cheques on and balances due by other banks in Canada and balances due by banks outside Canada. The total of such cash reserves usually amounted to about 10 per cent. of deposits, but was always strengthened by a high percentage of further " quickly realisable assets " or " secondary reserves ".

When the Bank of Canada opened for business the banks became obliged to keep reserves, equal to 5 per cent. of their deposit liabilities in Canada, in the form of a deposit with the central bank or of notes of the Bank

of Canada. The chartered banks are also required to maintain with the central bank or elsewhere " adequate " reserves against liabilities outside Canada,[1] furnishing information to the Minister of Finance from time to time, to show that this is being done. As a result of unsettled exchange conditions a large proportion of reserves against liabilities outside Canada is necessarily held abroad,—in sterling and less frequently in other currencies.

The 5 per cent. requirement does not appear to be severe compared with requirements in, for example, the United States, but there are no provisions for the reserve being drawn upon, so that in practice a further 5 per cent. is needed for till and clearing purposes. Moreover, the 5 per cent. reserve is to be maintained against time as well as against demand deposits,[2] and time deposits amount to about 70 per cent. of total deposits in Canada. Reserves requirements appear severe compared with those enforced in other parts of the Empire, for example, in India, 5 per cent. against demand and only 2 per cent. against time deposits ; or in New Zealand, 7 per cent. against demand and 3 per cent. against time deposits.

Canada thus belongs to that group of countries in which cash reserves do not so much secure liquidity in time of emergency as protect depositors in the case of ultimate liquidation (see p. 18).

Note issue

The chartered banks are still permitted to issue notes, and indeed their notes constitute the bulk of paper money in the hands of the public. Since the inauguration of the Bank of Canada in 1935, however, these issues are to be gradually superseded by notes issued by the central

[1] This is important, for these deposits are said to be more liable to sudden withdrawal than deposits held for Canadian customers.

[2] The distinction between time and demand deposits is that the former are usually subject to 15 days' notice of withdrawal. In fact, however, the distinction is frequently overlooked and cheques are drawn against time deposits.

bank. The volume of notes which each of the ten banks is now permitted to issue is based upon the amount of its unimpaired, paid-up capital in 1935, but it is being reduced by 5 per cent. per annum up to January, 1941, from which date it will be annually reduced by 10 per cent., until it equals 25 per cent. of unimpaired, paid-up capital. At this figure it will remain, until parliament enacts otherwise. Whether or not it will be finally extinguished is of little moment, for it is of course only important, from the point of view of control, that the central bank should regulate the fluctuating margin of the note circulation of the country.

Much of the Bank Act is taken up with provisions concerning the note issues of the chartered banks, but they will receive no further consideration here (as note issue is not conceived to be properly the function of commercial banks), except that it may be added that no bank is allowed to pledge, assign or hypothecate its notes, and that no advance or loan made on the security of the notes of a bank is recoverable from the bank. A similar provision exists in the United States in respect of national bank notes, and the aim is clearly to prevent bank notes being quoted at a discount.

Business and powers of a bank

The business and powers of the chartered banks are defined by law. They may open branches or agencies; deal in gold and silver coin and bullion; lend money and make advances on, deal in, discount and take as collateral security bills of exchange, promissory notes and other negotiable securities, or the stock, bonds, debentures and obligations of municipal and other corporations, whether secured by mortgage or otherwise, or Dominion, provincial, British, foreign and other public securities; and engage in " such business generally as appertains to the business of banking ".

Certain transactions are specifically forbidden :—the sale and purchase of goods; engagement in any trade or

business whatsoever; the sale or purchase of, or contraction of loans against, the capital stock of any Canadian bank; loans to or on the security of officers (but see p. 112); loans to directors without the approval of two-thirds of the directorate.

The only restriction mentioned in the last paragraph which might be commented upon is that prohibiting banks lending against the security of any bank stock. This extension of the prohibition of banks lending against their own stock was made in 1879, and is justifiable in so far as the fortunes of the banks are so bound together that, if it is dangerous for a bank to lend on its own stock, it is equally risky for it to lend on the stock of any other bank; and, what is more important, in that bank stock is subject to double liability and is thus an undesirable type of security for a bank loan.

The act also prohibits a bank from lending money or making advances upon the security of goods, wares and merchandise, except as authorised by the act. This prohibition serves to introduce one of the most interesting parts of the act,—section 88. Section 88 states that a bank may lend money to any wholesaler, purchaser or shipper of or dealer in products of agriculture, the forest, quarry and mine, or the sea, lakes and river, on the security of such products; to farmers on the security of threshed grain; to wholesale manufacturers on the security of goods, wares and merchandise manufactured by them or procured for manufacture; to owners or tenants of land for the purchase of seed or fertiliser, on the security of prospective crops; to a person engaged in stock raising upon the security of live stock. Further, the security may be taken in a form set out specially in a schedule of the act, by which the borrower retains the goods in question in his ownership and possession, delivering to the bank not documents of title or a charge, but merely a simple assignment, though the bank receives thereby (subject to certain restrictions) a first lien on the goods, just as if it held the title to them.

The special privilege thus afforded to banks (though its purpose is to benefit the trader rather than the banker) is, of course, in contravention of the well-established principle of law, applicable to lenders in general, that a lender cannot receive, by way of pledge, an article which his creditor retains in his own ownership or possession. In a country in an early stage of development, however, and with small accumulations of working capital, the provision has proved of inestimable value, and it has resulted in negligible losses. It enables the borrower to borrow, in particular, on goods in process of manufacture, transit or sale, and on natural resources in course of extraction or growth.

Since 1923 the intention to borrow under section 88 must be registered, such registration being deemed notice to other creditors of the customer. This provision was inserted to meet criticism directed against the injustice to other creditors which had sometimes arisen from non-disclosure of the bank's prior lien. The banks incur no liability, the onus of registration being on the borrower, but the banker should see that he receives the official acknowledgment of registration issued by the Assistant Receiver-General. The law also contains detailed provisions relating to the bank's rights, procedure on default, the substitution of one security for another, seizure and sale, the disposal of the proceeds of a sale, fees for registration, cancellation of security and so on. It may be added that section 88 does not, naturally, prevent a bank from acquiring warehouse receipts and bills of lading as collateral security, thus vesting in itself the right to the goods to which they relate.

This part of the Bank Act was discussed by the Royal Commission in 1933, and the Commission, after commenting on the anomalies of it, stated that it was satisfied that its utility was not spent, though the time might come when the advantage of retaining it might be questioned.

The act also contains provisions specifically permitting

banks to lend on the security of standing timber or rights to cut or remove timber, provided that the instrument evidencing such security is duly registered against the land on which it stands. A bank may also lend to receivers, liquidators, etc., provided they have been authorised to borrow, and may take security for such loans. It may also advance money in aid of the building of a ship and take security in the form of a mortgage on it, but may not otherwise make advances on the security of ships or other vessels.

Real estate

Every bank is specifically authorised to acquire and hold real estate for its actual use and occupation. It is also permitted to take, hold and dispose of, by way of *additional* security for debts due to it in the course of its business, mortgages and pledges of real and personal property, except real property exempt from seizure under writs of execution ; and to take and hold the rights of vendors or purchasers under agreement for the sale or purchase of real or personal property. A bank may also purchase any lands or real or immovable property offered for sale (e.g. under an order of the court) as belonging to a debtor of the bank ; offered for sale by a mortgagee having priority over the bank ; or offered for sale by the bank itself under a power of sale given to it by a debtor, provided that the sale has been duly advertised. In such cases it purchases as any individual would do. A bank may also acquire an absolute title to real property mortgaged to it as security (e.g. by procuring a foreclosure).

In short, while the banks are virtually forbidden to speculate in land, they have full rights to protect loans and advances by acquiring or realising real estate. No bank, however, may hold any real or immovable property, however acquired, except such as is required for its own use, for over seven years, though the Treasury Board may extend this period for further periods, not to exceed

five years in all.[1] The period during which a bank may hold land which it has acquired by foreclosure, or in enforcing security, is a comparatively generous one, and should afford it the opportunity of realising at a reasonable figure.

Each bank is required to make an annual return to the Minister of Finance of the " fair market value " of all real and immovable property which it occupies and uses, with a statement showing the registered owner (if other than the bank), any mortgage to which it is subject, and the extent to which each parcel of real property is not actually used and occupied by the bank. The penalty for infringement of the law regarding real estate is forfeit of the property to the state.

It must not be imagined from the foregoing that Canadian banks are free to make loans on the security of land. The act states that advances upon the security, mortgage or hypothecation of any lands, tenements or immovable property are forbidden. The apparent contradiction is explained by the word " additional " italicised above. Mortgages of land may only be taken as additional security for a loan primarily protected by some other form of security.

The prohibition of loans on the security of land is doubtless justifiable in a new country on the grounds of experience alone, for in such countries land values fluctuate widely. The law, however, is depriving the banks of a valuable form of security, and, in the writer's view, this will in time be recognised.

Investment operations

There is no restriction on the investment operations of the chartered banks. It was suggested to the Royal Commission that the banks should be prohibited from selling securities direct to the public, and from tendering for and acting as agents in connection with new issues. This suggestion was put forward, not with a view to

[1] Under an amendment of the year 1900.

assuring the safety of the banks, but to safeguard the investment bankers from competition. The Royal Commission, however, declined to make any proposals in this connection, though strongly urging the banks to refrain from dealing in or distributing for their own account securities of any but the highest class, and to concentrate on the securities issued by governments, municipalities and public or semi-public bodies.

The act does, however, contain one provision relating to securities. The name of a bank may not appear, except as receiving applications, on any prospectus or advertisement, unless it is issued by or on behalf of the Government of Canada or of a province, local government unit, railway, express, telegraph or telephone company, the rates of which are fixed, or the tariff of the tolls of which is approved, by the Board of Railway Commissioners for Canada; or unless the securities to be issued pursuant to the prospectus or advertisement are guaranteed by the Government of Canada or a province. There is thus an important and wholesome restriction on the issuing and underwriting activities of the chartered banks.

Rates of interest and charges

The maximum rate of interest on all types of bank loan or discount is legally fixed at 7 per cent. and bank officers exacting higher rates are made personally liable. It would appear, however, that this provision has not always been strictly observed,[1] and that in the west rates of 8 per cent. and higher have been charged, when risks have been great. It was to meet this that the above-mentioned penalty was imposed in 1934. Each bank is required to make returns in June and December in each year to the Minister of Finance, giving details as demanded of the interest and discount rates charged by it.

Although usury laws are out of date, the fact that there exists some sort of common policy on the part of

[1] Report of the Royal Commission, 1933, p. 72.

the banks with regard to interest rates has led to the view that there should still be maintained some means of protecting the public against exploitation. It has also been argued that banks should be discouraged from making loans involving such risks as justify the charging of higher rates. On the other hand it has been contended that branches cannot be maintained in remote parts unless higher rates are charged, and that, if customers are prepared to pay higher rates, they should not be prevented from doing so. To fix a maximum rate of interest is the same as fixing a minimum degree of security, and results in persons who cannot provide this being unable to borrow. To look at the matter from a broader angle, the provision may well hinder the central bank in achieving the aims of its policy, for it is one of the functions of the Bank of Canada to publish a bank rate with a view to controlling the price of credit. The Royal Commission recommended either repealing the restriction or imposing a penalty for contravention, with a bias towards the former, and it is the writer's opinion that experience will in due course lead to its repeal. If some control of commercial bank rates is required, a rule fixing these at a given number of points above bank rate is preferable.

Certain commission charges are also regulated by statute. Commissions for the collection of discounted notes, bills or other negotiable instruments payable at a bank's own branches are fixed at a maximum of $\frac{1}{8}$ per cent., though a bank may make a minimum charge of 15 cents. For the collection of discounted instruments payable at the branch of another bank, commission may be charged at $\frac{1}{4}$ per cent. (with a possible minimum of 25 cents), provided that that branch is not at the same place of business as the collecting bank. The banks also make charges for the collection of cheques, but these are not regulated by law. It must be remembered that in a country with an extended territory and in which cheques for collection are credited to a customer's account as soon as they are received at the bank (as in Canada), collection

charges include some allowance for interest. The Royal Commission recommended that the banks should reduce commissions for collection and recoup themselves by making heavier charges for carrying active accounts. The activity of an account is undoubtedly a better basis for charges than the value of the turnover on it (and this is what percentage collection charges amount to), but if the system were adopted in Canada it would mean that cheques for collection could only be credited after they had been presented and paid.

The only provision of the act relating to charges for the keeping of accounts is one which forbids such charges being made, except as a result of express agreement between bank and customer. The regulation of bank charges is, of course, extremely rare in commercial banking legislation.

Contrary to the general practice ruling in other countries with banking codes, there is no legal limitation on the rates of interest paid on deposits. The chartered banks are expressly authorised to allow any rate of interest.

It will be seen, therefore, that the main purpose of legislation affecting rates of interest and bank charges is the protection of customers. This may be a reaction to past extortions on the part of the banks (though it dates from early times), but is not always justifiable in the light of modern theory on the control of bank interest rates, debit and credit.

Amalgamations

Before the year 1900 the special approval of parliament was necessary for the amalgamation of two banks. A provision of the law inserted at the decennial revision of that year, however, established a new procedure. A bank may now sell all or any of its assets to another bank, but prior consent is needed from the Minister of Finance, from the shareholders of the selling and purchasing banks, and from the Governor-General in Council. Further, the

Governor-General may not give his approval unless the agreement has, in addition to the consent of the Minister of Finance, the recommendation of the Treasury Board. This might appear to be a complication of procedure, but it is in effect a simplification, for the difficulties of a special act of parliament are avoided. At the same time the control of amalgamations still rests in the hands of a central authority.

The act contains other details concerning amalgamations, but they do not merit attention for our purpose.

Audit and inspection

The chartered banks are annually subject to a shareholders' audit and an inspection at the hands of a government authority, as well as to the internal inspections usual in a branch banking system.

Prior to 1913 there was no provision in the act for a shareholders' audit, but the revision of that year introduced one on the lines of that provided for by the English Companies Act. There was a further amendment in 1923, and the affairs of each bank and of any companies it controls are now required to be audited annually by two professional auditors, members of an incorporated institute or association of accountants, and chosen by the shareholders. The names of eligible auditors are published annually in the *Canada Gazette* and the Minister of Finance has the virtual right to control that list. There are thus reproduced to some extent certain of the features of the Swiss system of audit. The two auditors chosen must be members of different firms, and if the same two persons or members of the same two firms are appointed for two years in succession, one of the two may not be appointed in the two years following. If a vacancy occurs during the year, the Minister of Finance appoints an auditor to fill the vacancy. There are thus elaborate provisions for an impartial audit.

The Minister of Finance is authorised by the act to require from time to time that the auditors of a bank

report to him upon the adequacy of the procedure adopted by a bank for the safety of its creditors and shareholders, as well as upon their own procedure in auditing the affairs of the bank. The Minister may, at his discretion, enlarge the scope of the audit or direct the making of a particular examination, as the public interest may seem to require. In addition to the ordinary auditors' report presented to shareholders, a special report has, since 1923, been required to be made to the directors, on the condition of the bank, bringing out matters which need rectification, and commenting on any loans, exceeding 1 per cent. of paid-up capital, which in the judgment of the auditors are inadequately secured. A copy of this second report must also be sent to the Minister. The law ruling in Canada thus goes far beyond anything existing in this country or indeed any other part of the Empire. It will be noticed that the Minister of Finance is not in this connection clothed with authority to take any action on receipt of an unfavourable report. It will be seen, however, that powers have been conferred on him in the case of insolvency brought to light by the Inspector-General of Banks.

The provision of government inspection, in addition to audit, was only initiated in 1924, and resulted from the failure of the Home Bank of Canada in 1923. A new office was created, that of the Inspector-General of Banks, who is an officer of the Department of Finance and is nominated by the Governor-General in Council, on the recommendation of the Minister of Finance. The Inspector holds office during good behaviour and has a staff of clerical assistants under him. He is required, once a year at least, to examine the affairs of each bank, specifically with an eye on the provisions of the act in matters that concern the safety of creditors and shareholders. He has access to all books, documents and securities, and may request any information that seems to him necessary. The Inspector makes a report on each examination to the Minister of Finance.

When the Bank of Canada was established in 1935 it

was authorised to require the Inspector to inspect the books of any chartered bank, for the purpose, in connection with the statutory reserves maintained with the Bank, of verifying each chartered bank's returns of its deposits and cash reserves. Under an amendment of 1936 this particular inspection is now carried out by the Inspector automatically.

Should the Inspector be satisfied that a bank is insolvent the Minister may, without waiting for the bank to suspend payment, appoint a curator to supervise the bank's affairs, with the object either of reorganising it or of winding it up.

Lastly, the act specifically states that the government undertakes no responsibility to depositors, creditors or shareholders for any default, negligence, mistake, error or omission in the administration of the powers or duties of the Inspector-General. The expenses of the Inspectorate fall on the Consolidated Revenue Fund and are not in Canada, as so frequently elsewhere, levied on the banks.

Government inspection was not introduced without great opposition on the part of the banks, but clearly a detailed banking code presupposes some system of inspection. The chief argument for it is that a special examination ordered by the Minister (and this was the system ruling prior to 1924) raises suspicions and causes panic. This is avoided by the institution of periodical examinations.

In addition to the audits and inspections established by statute, there are internal bank inspections. Each branch is inspected annually or more often, if necessary, and an inspection report presented. The banks' own inspectors are probably concerned with considerations other than those which auditors and government inspectors have in mind. To some extent, however, there is overlapping. Auditors examine not only the central accounts, but also the balance sheets from the branches, and in addition, also verify the cash at some of the larger branches. The investments of each of the banks are either examined personally by the auditors, or certificates

of their existence are provided. The auditors also make inquiries into all the larger loans.

There is thus a high degree of organised control over Canadian commercial banks, and it would appear to have the merits both of efficiency and of cheapness.

Returns

Certain returns and reports have already been alluded to: auditors' reports to the directors of a bank must be sent to the Minister of Finance, as must also the Inspector-General's reports; returns of rates of interest charged are addressed twice a year to the Minister; an annual return of the fair market value of real estate held is also made to the same authority. These are, however, far from being the only returns required.

Every bank must deliver to the Minister of Finance and to the Bank of Canada a monthly return of assets and liabilities on a form set out in a schedule of the act (which is subject to amendment by the Governor-General in Council). This schedule lists liabilities under seventeen heads and assets under thirty. The large number of items is attributable to the facts that Canadian banks have branches outside the Dominion, that they issue their own notes and that the deposits of the Dominion and provincial governments, and of other banks at home and abroad, are segregated; while on the assets side investments are analysed under five classifications, and loans are required to be subdivided according as whether they are made to other banks, customers in or out of Canada, the government, provincial governments, or local authorities. It may be added that the Minister of Finance may also call for special returns. Since 1923 all returns made under this section of the act are required to be accompanied by a statement of the assets and liabilities of all companies controlled by the bank, and the interest of the bank in such companies must be shown separately. This was in accordance with British practice and preceded American legislation on these lines.

It may be mentioned, in connection with statements of assets and liabilities, that no bank, unless it has the permission of its shareholders, may bring back to its published accounts any sum which it has appropriated with their consent and approval from its profits for the writing down of bank premises or other assets. The excessive writing down of bad debts and premises is the most usual method of constituting hidden reserves, and banks sometimes find it convenient in bad times to bring back reserves so built up. This practice is, however, forbidden in Canada, unless it is duly advertised by reference to the shareholders. Even as the law stands, however, it is doubtful whether there is much to prevent the constitution and use of hidden reserves. There is nothing to prohibit a bank from providing for bad debts before arriving at profits, and such provisions would neither have the express consent of shareholders nor be appropriations from profits. When the chartered banks sold their holdings of gold to the central authorities in 1935 and, as a result of the revaluation, made a profit on the transaction, no entries appeared in the published accounts of the banks. Here, too, therefore, it would appear that a hidden reserve was constituted, though it did not involve the writing down of assets, appropriation from published profits or the express consent of shareholders.

Annual returns are made to the Minister of Finance of the names and addresses of directors, the concerns of which they are partners or directors, and the names of the presidents and vice-presidents. Changes in the office of chief accountant or general manager are required to be notified to the Minister. A further return which has been required annually since 1871 is that of the names and addresses of shareholders, their shareholdings and the amount remaining to be paid on them.

Canadian banks make one rather unusual return. Each bank is required to send annually to the Minister of Finance a list of all dividends which have remained

unpaid for more than five years, and of all amounts or balances in respect of which no transactions have taken place, or upon which no interest has been paid during the previous five years. This return must set out the names of the shareholders or creditors to whom the dividends or balances are due, their last-known addresses, the amounts due, and certain other particulars. What subsequent action is taken, beyond the publication of the returns in a Blue Book, is not mentioned in the act. A return is also required of all certified (i.e. marked) cheques, drafts or bills of exchange issued by each bank and remaining unpaid after five years.

A return of more moment than the last-mentioned is that which is made annually to the Minister of Finance and classifies according to industries and businesses the loans made by each bank. Yet another return sets out deposits in five categories, according to size.

All the returns except the two mentioned in the last paragraph are placed in due course before parliament; the last two are only presented in the form of an aggregate for all chartered banks.

The inauguration of the Bank of Canada has resulted in further returns. Every chartered bank must make a return to the Bank once a month showing for each day in the preceding month the amount of its deposit liabilities within Canada and also of its holding of bank notes and deposits with the Bank, together with a daily average for each. The daily average of deposit liabilities is the basis for determining the amount of reserve which each bank must hold in the following month.

Under the Bank of Canada Act no chartered bank may hold shares in the Bank. Each chartered bank must submit a return every year, stating that the provisions of this section of the law have been observed.

Lastly, the statement required by law to be sent annually to shareholders is also to be sent, with a copy of the profit-and-loss account and of the minutes of the annual general meeting, to the Minister of Finance. In

this statement (which is a balance sheet for the end of the year) assets are set out under twenty-five heads, liabilities under fifteen.

Every decennial revision of the Bank Act has contained some new feature relating to returns, and they now appear to be as detailed and complete as can reasonably be required.

Canadian Bankers' Association

An interesting feature of Canadian banking is the institution and statutory recognition of the Canadian Bankers' Association. It was formed in 1892 as a voluntary association of banks and bank officers, to promote generally the interests and efficiency of banks and bank officers and the education and training of those contemplating employment in banks, and more specifically to watch legislation and court decisions relating to banking. In 1900 the Association was incorporated by parliament, and empowered to establish and regulate clearing houses, of voluntary membership. The Royal Commission's Report gives the following account of its subsequent powers: "At the revision of the Bank Act in 1900 the Association was assigned certain functions, including control by a curator over suspended banks pending the appointment of a liquidator (or the resumption of business). The Association was also given supervision over the issue and destruction of bank notes. The by-laws of the Association were made subject to approval by the Treasury Board. In 1901 the by-laws of the Association came into effect according to law. They required from every chartered bank doing business in the Dominion a monthly return, under penalty of fine, showing all the details of their circulation. Provision was also made for an annual inspection of the circulation account of each bank." The Association is not concerned to formulate a monetary policy for the banks, but it has made possible a considerable degree of co-operation between them.

This experiment of giving to a controlled element in

the community authority to control itself has proved highly successful, and the Association enjoys a considerable measure of prestige in the Dominion, though its outlook is naturally conservative.

The Association has, however, now lost one of its powers—that of appointing curators—to the Minister of Finance. It may be added here that the system of appointing such curators to manage a bank pending reorganisation or liquidation is not often provided for in banking codes, but the policy of putting banks under the control of " conservators " in the United States in 1933 is closely comparable with it.

Controlling authorities

The control of commercial banking in Canada is vested primarily in the Minister of Finance, not, as might have been expected, in an independent, non-political inspectorate. This, however, has never been made a ground for complaint, as far as can be ascertained. Returns are made to the Minister, auditors report to him ; his consent is needed for amalgamations ; he controls the list of auditors and the scope of audits ; he may even appoint an auditor in certain circumstances ; he may appoint a curator when a bank is insolvent ; and may order special examinations and inspections. The next most important authority is, perhaps, the Treasury Board, again a political body, for it consists of the Minister of Finance, the Receiver-General and four Ministers belonging to the Privy Council for Canada, nominated by the Governor-General. The Board, which is, in effect, a committee of the cabinet, has fewer but more responsible functions: it issues certificates authorising new banks to commence business; its approval is needed for increases and reductions in capital ; the Board has the power to extend the period for which a bank may hold real estate which it does not occupy ; amalgamations require its recommendation and the by-laws of the Canadian Bankers' Association its approval: finally it had important duties in connection with the emergency issue

of bank notes under the Finance Act, 1914. Thirdly, there is the Inspector-General of Banks, whose duties have already been fully described. His function is primarily to see that the law is observed and he is responsible to the Ministry of Finance. Fourthly, there is the Canadian Bankers' Association, which is, however, largely the agent and adviser of the Treasury Board.

The Bank of Canada has also certain functions of control, especially in connection with the reserves of chartered banks. It is also authorised, for the purpose of conducting open-market operations, to buy and sell in the open market securities, cable transfers, bankers' acceptances and bills of exchange of certain kinds and maturities ; and to make advances to and to rediscount bills of exchange and promissory notes for the chartered banks. How far the Bank will effectively control credit policy still remains to be seen.

Lastly, mention must be made of the Governor-General in Council and of the Canadian Parliament, both of which authorities have certain functions in banking control, though the function of the latter is restricted to the incorporation of new banks and the periodic review of the Bank Act itself.

There thus exists in Canada what might be described as a multiplicity of supervising authorities, but as even the Bank of Canada is virtually under government control, and the Inspector-General is a civil servant, responsibility is, in fact, placed on the government of the day, to whom, presumably, the Minister of Finance and the Treasury Board must account.

Conclusion

The Canadian banking code seems to be adequately fitted to fulfil its purpose, which is the protection of depositors and shareholders. There have been 26 bank failures since 1868, but the majority of these are said to have been due to mismanagement and dishonesty on the part of officials at the head offices. Such dangers have

now been dispelled, both by the character of the banks now in existence and by the provision of an annual shareholders' audit (introduced in 1913) and government inspection (1924). Since 1913 there have been only two bank failures. Safeguarding requirements have been adequate, yet not, apparently, oppressive or unreasonable. At the same time the student cannot but compare in his own mind Canadian and American experience, and he is forced to the conclusion that the prime factor making for the safety of Canadian banking has been its development in accordance with branch banking principles. The advantages which this has given in the shape of trained staffs, the control of small offices and the spreading of risks inevitably outweigh the advantages accruing from any detailed system of legislative control.

CZECHOSLOVAKIA

Note.—Where Czech names and terms are used in the following pages, the German equivalent has been added for the convenience of the reader.

CZECHOSLOVAKIA

Introduction

THERE had already grown up before 1914 in Bohemia, Moravia and Slovakia, a Czech and German-Czech banking system, with its centre in Prague and to some extent independent of the Austrian and Hungarian banks. The greater part of the financing of the important industrial and commercial firms was, however, carried out by the large Vienna and Budapest institutions.

With the creation of the Czechoslovakian Republic in 1918, new developments took place. A rapid expansion in the business of the existing banks occurred, since the financing of industry and trade now devolved upon them instead of upon the Austrian and Hungarian institutions; this extension of their field of activities made large increases in the capital of the banks necessary. Many new banks were also formed to help in the task of financing the new state. Finally, as part of the government's nationalist policy, a series of regulations was passed which required the branches of Austrian and Hungarian banks in Czechoslovakia (of which there were 111 in 1918), either to establish themselves as local banks or to associate themselves with already existing Czech banks. Both processes took place. The Oesterreichische Creditanstalt, for example, made over its branches to the Bohemian Discount Bank, while the Mercur Bank of Vienna organised its branches into the Czech Commercial Bank; a similar procedure was adopted by several other foreign banks. In some cases, foreign capital was provided in the establishment of these banks. The rapid expansion of banking

in those years can be seen from the following figures :—[1]

	1919	1920	1921	1922
Number of banks . . .	28	37	40	37
Capital paid up (million Kc.) .	215	1329	1548	1791

The Czech banking system is one of considerable complexity. In addition to the joint stock banks which carry on the normal banking business of *banques d'affaires*, there exist banks without share capital, limited liability companies and private banks, all of which carry on specialised business of various kinds, co-operative credit associations and their central organisations, agricultural district banks, advance banks and small joint stock credit institutions in Slovakia and Ruthenia. While only the joint stock banks are, properly speaking, commercial banks, yet the other institutions compete with them for deposits, of which the commercial banks held, for example, only 40 per cent. of the total in 1928 and 20 per cent. in 1936, despite the fact that they possessed over a half of the total capital and reserves. It should be noted, however, that the deposits of the other institutions are mainly in the form of saving deposits.

Following the tradition of their Austrian and Hungarian predecessors, the Czech joint stock banks have maintained very close connections with trade and industry through share ownership, by granting long-term advances on current account, and in some cases by nominating their own representatives to the boards of the companies in which they are interested. Moreover, the Czech banks usually have commercial departments—a practice not uncommon in Central Europe—which deal with the products of the concerns under their control. The activities of the commercial departments have, however, been circumscribed by law since 1924, on account of the risk of loss arising from dealing in commodities, a danger which was exemplified in the case of the Bohemia Bank,

[1] *Memorandum on Commercial Banks, 1913–29.* League of Nations.

which failed in 1922 through losses incurred in handling goods.

During the early years of boom and inflation the banks were prosperous, but the depression, which began in 1922, caused a number of banks to fail, mainly as a result of risky industrial finance and the doubtful probity of their managements. Other banks—mainly small—had to be reorganised. The number of banks declined from 40 in 1921 to 33 in 1924, although the capital structure, as a whole, increased in this period.

Towards the end of 1924 three laws were passed which, with the modifications introduced in 1932, 1933 and 1936, form the basis for the control of banking in Czechoslovakia. The first of these laws was dated 9th October, 1924, and provided for the creation of a fund, called the Special Guarantee Fund, to help banks to cover losses suffered through " special post-War conditions ". The second, dated 10th October, set up a so-called General Guarantee Fund, with the object of " encouraging savings by increasing the safety of deposits and ensuring the best possible development of banking ". A third law was passed simultaneously and was divided into three sections. The first provided safeguards against the loss of savings deposits; the second set out special regulations affecting joint stock banks; the third provided for the compulsory auditing and inspection of banks by an Auditing Association formed under the auspices of the government.

In the years that followed, up to the onset of the world economic depression, several reconstructions and amalgamations were arranged by the Ministry of Finance, which derived extensive powers from the acts cited above. The period was characterised by an increase in the participations of banks in industry due to an attempt to oust foreign influence—mainly Austrian—from Czech industries by the purchase of shares in industrial firms (the Zivnostenska Banka with its " nationalist " policy was particularly prominent in this respect) and to the extensive raising

of capital by individual firms through the banks; by intense rivalry between the large Prague banks, despite the existence of a bank cartel; by the extensive purchase of their own shares by the majority of the banks from 1930 onwards, in an attempt to retain the confidence of their depositors.

The world economic depression was not felt in Czechoslovakia until after most other countries had suffered severe shocks to their general economic and financial systems. The events in Austria, Germany and Central Europe seemed to have little or no effect on Czechoslovakia and it was hoped that the country would escape a serious crisis and banking reorganisation.

In 1932, however, it became obvious that the banks had incurred severe losses and it was only by energetic measures taken by the government that a crisis was averted. The committees in charge of the two Guarantee Funds formed in 1924 worked out such details for rationalising the banks as were considered essential, while the government took powers under a new law published on 21st April, 1932, to enable extensive help to be given by the Funds and by the government to banks in need of reconstruction.

The reconstruction took three forms. Some twelve banks—both Prague and provincial institutions—received help from the two Funds in the form of bonds to be disposed of for cash, while the state wrote off deposits which it had placed with the Anglo-Czechoslovakian Bank and the Moravian Bank. Secondly, the state gave a guarantee for credits granted to the banks by certain public institutions. Lastly, amongst those banks which did not have recourse to help from the Funds or from the government large reductions in share capital took place, on the recommendation of the Ministry of Finance, and the banks' holdings of their own shares were cancelled. The Zivnostenska Banka, the Bohemian Discount Bank, the Bohemian Union Bank and the Commercial and Industrial Bank were amongst the banks which reduced their capital.

In addition to the measures designed to meet the emergency, the new legislation amended and extended the previous law in several important particulars, with the object of improving the quality of bank management. Provision was also made for the formulation of agreements regulating competition and interest rates.

Two developments in the sphere of the control of banking have taken place since the reconstruction period. In 1934 a rediscounting and lombard institution was formed with the object of mobilising credit and regulating the market for government securities. In 1936 a department was set up in the National Bank for the control of commercial credits.

In subsequent pages a detailed analysis of the banking law will be undertaken, but certain generalisations can with advantage be made here. Control is in the hands of the Ministry of Finance, which has extensive powers over the banks. There are, however, very few positive regulations of the sort usually found in bank laws, the main emphasis being laid on negative regulations which provide help if the banks find themselves in difficulties, and, on the other hand, impose heavy liabilities on those responsible for the administration of the banks. Great importance is also attached to control through supervisory boards and to compulsory audit and inspection, while banks are obliged to observe the terms of official agreements governing competition and interest rates.

Special Guarantee Fund[1]

By the law of 9th October, 1924, as amended in April, 1932, a Special Fund was set up out of contributions from member banks and the state, to be used for the partial cover of losses arising from changed post-War conditions.[2] The members of the Fund are composed of various types of financial institution including co-operative

[1] Zvlastni fond: Spezialfonds.

[2] Banks were originally required to apply for assistance within six months of the passing of the law of 1924.

associations; advance offices; saving banks; joint stock companies with or without limited liability "which carry on banking business and accept savings deposits or current accounts".

Contributions to the Fund for any year are payable only if a bank's accounts for the preceding year show a profit. In the case of joint stock companies, the contribution is based on a sliding scale according to the rate of dividend paid, and is calculated on the share capital. For co-operative societies and savings banks, a flat rate of 10 per cent. of net profits is payable. The committee of the Fund (see below) is empowered to examine the books and accounts of member institutions to see if the amounts written off are justifiable. If the income of the Fund from all sources is sufficient to pay interest and amortisation on bonds issued by the Fund, the contributions may be reduced by the government. The contribution of the government, normally amounting to Kc. 50,000,000 a year, may also be reduced in similar circumstances. All contributors must submit balance sheets, so that the amounts of their contributions may be checked.

The Fund is administered by a committee of twenty-one, all of whom are nominated and appointed by the government on the recommendation of the Ministry of Finance.[1] The groups of banks (four in number as defined in the law) are equally represented; the other members of the committee are civil servants or persons not connected with banking. The positions are honorary. On the expiry of their term of office, members of the committee are bound to continue to observe secrecy regarding the business of any institution which has come under their supervision. The obligation may only be removed by the Ministry of Finance, after hearing the views of the bank in question. Government officials who

[1] In this and in other similar cases the Ministry of Finance is required to consult the Ministries of the Interior, Trade, Agriculture and Social Services.

have been members of the committee may not either directly, or indirectly, enter the service of a bank which has received assistance from the Special Fund, within a period of five years from retirement or leaving the state service. In special cases, however, the Ministry of Finance may make exceptions to this rule.

The committee drew up its own constitution, which had, however, to be approved by the Ministry of Finance. A statement of payments and receipts has to be made annually, and submitted to the Ministry of Finance.

The committee ascertains the losses suffered by the banks applying for assistance, and draws up a plan of assistance which must be approved by the Ministry of Finance. Banks which belong to a recognised audit association have to submit to an audit before they apply for assistance; all others must apply direct to the committee, which is itself empowered to examine their books. "Losses", for the purposes of the Fund, are defined as those caused by a decline in the value of investments and in the prices of goods, and by bad debts. Elasticity is, however, given to the interpretation of "losses", since those due to other causes may be put before the committee for consideration if important public interests are affected.

Claims for help are accepted or rejected by a special commission consisting of those members of the committee who represent the banking group to which the applicant belongs, together with official members, although the consent of the government must be obtained before help can actually be granted. Assistance is normally given in bearer bonds—which are disposed of by the banks receiving them—but in cases affecting public interest, partial cash grants may be made. The total of the grants of the Fund—which must be repaid gradually [1]—is limited to a sum the interest on which (reckoned at at least 4 per

[1] The committee may require that assistance received be repaid out of net profits, provided that the building up of reserves and the payment of dividends are not thereby endangered.

cent. per annum) plus redemption payments (sufficient to amortise the sum within forty years) can be covered by the regular income of the Fund. The bonds, which may be issued by the Fund up to the amount of the losses to be made good by the Fund, must bear a minimum interest of 4 per cent. and be redeemable within forty years and must be in a form approved by the Ministry of Finance. These bonds are guaranteed by the government, and member banks are required by law to take them up, when issued, up to ½ per cent. of their deposits.

Perhaps the most important provision of the law relates to the imposition of conditions for the granting of assistance, such as, for example, the complete reorganisation of the bank, or the appointment of trustees, or of a commission of control to take over the administration of it (see also p. 154).

General Guarantee Fund [1]

The second of the three laws passed in 1924 introduced a scheme, since modified in an act passed in 1932, for the guarantee of deposits. A General Guarantee Fund was established with the object of "promoting savings by making deposits more secure and encouraging the extension of banking in the Republic". It differs from the Special Fund in three main particulars. First, it is self-supporting; secondly, certain types of co-operative society are excluded; thirdly, the General Fund can intervene in favour of depositors without awaiting an application for assistance from the bank concerned.

The members of this Fund are institutions which accept savings deposits or current accounts. They are divided into three groups, the first comprising mortgage and savings institutions, the second mainly co-operative credit societies, and the third other banks, including joint stock banks. If any dispute arises as to whether a bank comes within the scope of the act or as to the group to which a bank belongs, the Ministry of Finance is

[1] Vseobecny fond: Allgemeiner Fonds.

empowered to give a binding decision.

The resources of the Fund are derived from contributions[1] from the members (3 per cent. of the interest paid on current accounts, savings deposits and short-term debentures), and from the profits arising from the employment of its surplus funds. If these contributions are not sufficient for the purposes of the Fund, bearer bonds carrying interest at not less than 4 per cent. may be issued with the permission of the Ministry of Finance, provided that the interest and amortisation payable do not exceed three-quarters of the Fund's current receipts. These bonds are guaranteed by the state and must be taken up by all members, if the committee of the Fund so require. From the contributions of each single group and the yield on investments in which the contributions are placed, a group fund is created on which the banks of other groups have no claim whatever.

The Fund is administered by a committee of fifteen representatives of the member banks. All are nominated and appointed by the government on the recommendation of the Ministry of Finance, each group being represented by five members. Their period of appointment is five years and the position itself is an honorary one. The committee must submit for the approval of the Ministry of Finance its balance sheet and statement of receipts and payments; these documents are published in the Official Gazette.

The Fund intervenes in two distinct ways. Every bank which has been a member for five years can apply to the committee for assistance, if it has suffered such losses or its liquidity is impaired to such an extent that its existence and the interests of its depositors are endangered. Every member bank is required to inform the committee as soon as it observes that it has suffered or is likely to suffer losses absorbing its reserves and absorbing or threatening to absorb a half of its capital. Failure to do so renders it ineligible for help in this way. Should

[1] In practice, these contributions are debited direct to depositors.

the bank omit to observe this procedure, any assistance which it subsequently demands may be refused except in so far as help is granted under the second method. When a bank informs the committee of its endangered position or makes a request for help, the committee investigates the bank's position thoroughly. The amount of help given (as far as possible in the form of loans) is determined by two considerations. The first is that the assistance shall be sufficient to enable the bank to function efficiently and that the bank is not so drastically involved in difficulties that the help would be of no avail. The second is that the committee must have due regard for the general interests of the members of the particular group upon whose funds the claim is being made.

If help given by the first method cannot possibly prevent the bank from failing, because its liabilities are not covered by assets, or if a bank neglects to inform the committee of its endangered position, then assistance from the General Fund is given in an amount sufficient to cover up to 80 per cent. of the claims of the general creditors and in particular of the depositors. If, however, the resources of the Fund are not sufficient for this purpose, a part of the grant may be devoted to the more complete satisfaction of a single group of creditors worthy of special treatment. Such repayment is, for example, refused to creditors who have demanded and obtained either directly or indirectly higher rates of interest than can be justified by the canons of sound deposit banking. The authority for determining whether or not such is the case is the Arbitration Committee for Cases of Unfair Competition (see p. 155). With the granting of such assistance, the rights of the bank against its directors and officials for compensation for losses pass over to the Fund.

In all cases in which help is granted, the committee is always at liberty to impose conditions such as the reorganisation of the bank in accordance with a plan drawn up by it, the institution of a moratorium, fusion with

another bank or even liquidation. A trustee or special commission is appointed to manage each bank receiving assistance, the expenses falling on the bank itself; if the orders of the trustee or the commission are not obeyed or are interfered with, the bank may be wound up. The act provides for the appointment of a State Commissioner or Commissioners by the government, in agreement with the Ministry of Finance, to superintend the working of the Fund.

The Czechoslovakian banking law gives, therefore, considerable powers to the committees of the two Funds to effect the reorganisation or liquidation of banks which find themselves in difficulties. Before 1932 these powers —employed in fact through the medium of the Ministry of Finance—were frequently used both to reorganise individual banks and to effect amalgamations, the Ministry of Finance considering that there were too many banks and that the competition which inevitably arose between them was unsound.

Formation of banks

Part II of the law of 10th October, 1924, as amended by the law of 21st April, 1932, applies exclusively to joint stock banks (*Akciove banky: Aktienbanken*), although the government is also empowered in another section of the 1932 legislation to regulate by decree the carrying on of banking business by individuals, partnerships (*Verejne obchodni spolecnosti: offene Handelsgesellschaften*) and limited partnerships (*Komanditni spolecnosti: Kommanditgesellschaften*). Such decree may prescribe—

(1) that a person or company can carry on such business or departments of it only with official sanction;
(2) conditions under which such permission may be granted and withdrawn;
(3) restrictions and control similar to those prescribed in the law of 10th October, 1924, as modified in 1932, for joint stock banks.

No joint stock bank can commence business unless it has received the permission of the Ministry of the Interior, in consultation with the Ministry of Finance and other Ministries concerned. Applications for a licence must be accompanied by a notarially attested copy of the constitution of the bank and details of the registration. Government authorisation must also be secured before any changes in capital or the constitution can take place. Permission must be obtained for the opening of branches or agencies and for amalgamations with other banks. The law expressly forbids the establishment of an independent bank to circumvent the provisions of the law making the opening of branches conditional on the permission of the government. This power to control the formation of branches was utilised extensively in 1928, when the Ministry of Finance refused permits for the opening of new branches, but suggested instead to the applicant banks that they should absorb banks already possessing branches in the towns in which it was desired to set up business. This is another example of the official policy of fostering amalgamations mentioned in previous sections.

The only regulations regarding capital and reserves are to be found in the section of the law dealing with savings deposits. Joint stock companies are allowed to issue deposit books after the Ministry of Finance, in consultation with the Ministry of the Interior, has given special permission, the intention of the legislators being to give savings deposits in joint stock banks the same security as is afforded by institutions formed for the purpose of receiving savings deposits. In order to be eligible for such a permit, a joint stock bank must have its head office in Czechoslovakia, have been established at least three years, have a capital of at least Kc.10,000,000 and a reserve against losses of 15 per cent. of capital. It has also to produce a certificate from the Auditing Association (see p. 153) stating that it has conducted a banking business successfully for at least three years and that its share capital and reserves as shown in its balance sheet

are fully represented by assets. The permit to accept savings deposits may be withdrawn if it appears that losses have been incurred which reduce the reserves to under 15 per cent. of the share capital, if the bank has been granted a moratorium or if the provisions of the law relating to savings deposits have been contravened. In the first-mentioned case, the permit will not usually be withdrawn if the directors, within two months, lodge securities, which are their personal property, with the Ministry of Finance.

Finally, if a bank has lost more than half its capital, or has contravened the regulations contained in its constitution, the law, or the stipulations imposed by the government at the time of granting permission to begin business, it may be liquidated by order of the government on the recommendation of the Ministry of Finance.

Administration

Joint stock banks are governed by (1) a board of directors (*Predstavenstvo : Vorstand*) and (2) a supervisory board (*Dozorci rada : Aufsichtsrat*), both of which are elected by the shareholders at the annual general meeting. The function of the supervisory board is to act as a check on the directorate. The constitution of a new bank is drawn up by these two boards, but it is to be noted that their members are not necessarily shareholders of the bank.

In practice the two boards are not the only administrative organs of a bank, as the law permits them to reserve in the bank's constitution the right to appoint a limited number of directors as an executive committee and to delegate administrative powers to "leading officials", who are defined as managers, branch managers and heads of departments.

Directors

The following cannot be members of the board of directors : attorneys of members of the board ; leading

officials or liquidators; persons convicted of certain offences; persons whose appointment would cause the transactions of the bank with a firm to be classed as prohibited transactions (see p. 159)—this exclusion may be waived by order of the supervisory board; civil servants except under certain conditions; former members of the government until after one year of their leaving office; members of the legislature. Persons holding fifteen or more appointments on the boards of directors, or as managers, of other institutions are excluded from the board of directors of a bank (see also p. 149). This provision, which presumably aims at making the directors concentrate their attention on their work at the bank, is extremely liberal compared with similar sections in other banking laws.

The directors are required " to administer the property and business of the bank with the care required of an ordinary business man ". More specifically, they must, as already described, draw up regulations governing the business of the bank and adhere to them in all their decisions and dealings. The board must also compile and publish quarterly statements and a balance sheet and profit-and-loss account in conformity with a model drawn up by the Ministry of Finance, to whom also these documents must be submitted.

The law next proceeds to elaborate conditions of employment. Contracts of employment between the bank and members of the board of directors and leading officials (with the exception of the officials of the control department) must be expressly approved by the supervisory board.[1] These contracts can only be concluded for a maximum period of two years or, if no specific time is fixed, subject to six months' notice. At the expiration of the period, the persons affected cease to be members of the administration and must also resign from boards in other companies on which they have represented the bank.

[1] For an account of the supervisory boards of the banks, see p. 150.

Furthermore, members of the board of directors with a service agreement, leading officials and other employees of the bank must not carry on business which would prevent them from devoting their exclusive interests to the affairs of the bank and must in no case hold more than ten positions in other institutions as directors or managers (see also p. 148). Such posts can, in any case, only be held with the permission—which may be withdrawn—of the supervisory board, which also determines what proportion of the fees received from outside employment shall be paid to these officials. Even so, this section is extremely liberal compared with similar provisions in the banking laws of other countries and it can have but a limited value.

In addition to laying down conditions of employment the law also imposes penalties for faults in management. If a bank suffers losses (as shown by the quarterly reports, balance sheet or reports of the Auditing Association) which absorb the reserves and reduce capital by more than 20 per cent., it can demand that unreasonably high salaries payable to the directors and leading officials be reduced. If difficulty arises over this point, an arbitration tribunal is to be established. This provision does not seem very rigorous, but such banks would in all probability be compelled to apply for aid from the government or from the Guarantee Funds, and such recourse might involve the imposition of further penalties. The law further states that members of the board of directors (and also of the supervisory board), together with the leading officials (defined as managers, managers of branches, and heads of departments), who have violated the regulations of the law or the various internal regulations or instructions, are responsible to the bank for losses arising out of their action. Their responsibility is joint, except in so far as the individual responsibility of each official concerned can be established. These liabilities are additional to those imposed on the directors of banks which accept savings deposits and to those which are imposed under a special

section of the 1932 law on officials of banks which have received help from public sources (see p. 154).

Under the law relating to savings deposits, protection is given to the depositor not by any state guarantee, but by a guarantee of the members of the board of directors of a bank accepting such deposits. Every director of a bank which accepts savings deposits and every manager of the main branch of such a bank guarantees (apart altogether from his liability to make good losses for which he, personally, is responsible) these deposits up to ¼ per cent. of the share capital of the bank, with a minimum of Kc. 50,000. If, however, the enforcement of the guarantee does not produce a total amount equal to 3 per cent. of the share capital, the difference is to be divided equally between all those liable. This liability applies only to directors or managers who were in office at the time of the loss, and action must be brought within six years of any such director vacating office, if it is to be valid against him.

If a bank accepts savings deposits without having received a permit or after a permit has been withdrawn, the directors are jointly and severally liable.

The liabilities become actual if the company goes bankrupt or compounds with its creditors, or if its reserves and 80 per cent. of its share capital are lost.

Supervisory boards

All joint stock banks are required to appoint a supervisory board. The board must consist of not less than five, nor more than seven, members to be elected from amongst the shareholders. Restrictions are imposed on the persons eligible for appointment, the following being excluded :—persons ineligible for the board of directors ; members of the board of directors or other administrative bodies of the bank ; members of the board of directors or of the supervisory board of institutions dependent on the bank or on which the bank is itself dependent ; officials in the service of the bank ; family connections of

members of the board of directors (exceptions may be made in this case). The period of service is for not longer than five years, but members may be re-elected. If the appointment is a salaried one, members must not receive fees from other sources.

The supervisory board must superintend the administration of the bank in all its aspects with the care required of ordinary business men. It can demand explanations and call for reports at any time, and can inspect all books, especially in regard to such matters as holdings of securities, cash, bills of exchange and other assets. Moreover, it must check the annual report and accounts, make proposals for the distribution of the net profit and forward the report to the general meeting of shareholders. The board must draw up a schedule of its duties according to principles laid down in a government order and place it before the Ministry of Finance for its approval. Any contravention of the rules of the schedule is considered negligence and punishable by law.

If the supervisory board finds that the provisions of the law or of the bank's own statute and internal regulations have not been observed by the management, and that the interests of the bank have thereby been damaged, it must inform the board of directors immediately. If the directors do not take action within a stipulated period, the supervisory board must inform the Inspection Department (see p. 153) or, in important cases, call a general meeting of shareholders.

The members of the supervisory board are liable to the bank for losses caused through their wrongful actions and are subject to special penalties (in common with directors and officials), if the bank is forced to have recourse to help from public sources.

Control departments

Apart altogether from the surveillance exercised by the supervisory board, the law provides for the establishment of a special internal control department for joint

stock banks employing more than twenty-five officials. The personnel of this department, including its manager (who must be a person eligible for election to the supervisory board or an official of the bank), must be appointed by, and the regulations governing its work drawn up by, the board of directors in agreement with the supervisory board. No member of this department may participate in the daily business of the bank. The supervisory board has the right to dismiss any member, but the board of directors only has this right in agreement with the supervisory board.

The main function of the department is similar to that of the supervisory board—to see that the regulations are complied with. An interesting supplementary duty contained in the law is that of observing whether the requirements of sound banking practice are complied with in the day-to-day business of the bank. In addition to supplying the managing directors with current reports, the control department is required regularly to issue written reports on its activities to the supervisory board; copies of these reports are to be laid before the directors.

If the supervisory board observes from the reports that infractions of the regulations or actions contrary to sound banking practice have occurred, it must take steps to ensure that the faults are remedied. If the management does not take the appropriate steps, the board can report the matter to the Auditing Association and can call a general meeting of shareholders.

State Commissioners

The control exercised by the supervisory board and control department of each bank is strengthened and supplemented by the appointment of a State Commissioner, to whom all details of the reports and findings of the control department submitted to the supervisory board must be reported immediately. This official can demand further information and a copy of the reports. The State Commissioner is generally a high official of the

Ministry of Finance, appointed by the Minister. He receives remuneration from the bank.

Inspection

As mentioned above, the law of 1924 established an Auditing Association which also has wide powers of control. All joint stock banks must belong to this Association. The Association has an Inspection Department, which is responsible to the Ministry of Finance and receives from it from time to time instructions concerning the kind, extent and date of any given inspection, and the bank to be examined. In addition to undertaking the inspection and auditing of the member banks, the Association has also the power of proposing the reorganisation or liquidation of a member bank and of itself participating in such activities.

The special department to which the work of inspection is entrusted is required to observe whether all statutory and internal regulations have been complied with and whether the security of the depositors and other creditors is amply safeguarded. Inspectors are given the fullest powers to enter all rooms and offices of the banks they are inspecting, to examine all books and to demand any additional information and reports. Further, they can request the central bank to inform them of the amount of credit granted to the bank examined; the central bank can, in its turn, ask for reciprocal information.

The inspectors send a written report of their findings to the managing board of the Association, which passes on the information to the bank examined and to the State Commissioner. The supervisory board and board of directors of the bank concerned must take appropriate steps, if the report shows that faults have been committed. Should no action be taken, the Association refers the matter to the Ministry of Finance for a final and binding decision.

Banks receiving help from public sources

Probably the most controversial section of the 1932 legislation was that setting out the conditions under which help would be given to banks in difficulties. The officials whose actions were held to be responsible for the failure of the banks were subjected to severe penalties.

Assistance from public sources is defined as help from the Special and General Guarantee Funds and help given by the state in the form of advances, deposits, payment of interest on loans obtained from another bank and guarantees. If it can be shown that the bank concerned was placed in the position of requiring such help through the actions of members of the board of directors or of the supervisory board, then those members are required (without prejudice to their liability to indemnify the bank for its losses) to pay back all fees and emoluments they have received in the discharge of their duties. If officials of the bank have been acting on either of these boards, they must pay back any wages received for such work. Repayment may be made retrospective, extending, in some cases, to three years before the granting of public help took place. These regulations may also apply if the bank becomes insolvent. The various liabilities enumerated above are also binding on persons who have left the boards and on the fortune of the married partner of any person liable, unless the partner can show that his or her fortune is independent.

A bank receiving public help may not use any profits for the payment of dividends and fees until losses have been covered and a general reserve amounting to 10 per cent. of capital has been created. A 4 per cent. dividend may, however, be paid after the Inspection Department has reported its findings, and with the permission of the government on the recommendation of the Ministry of Finance, provided that losses have been redeemed and a reserve fund has been built up. Repayment of the capital received from public sources is to begin as soon as the

bank has covered all its losses and the 10 per cent. reserve has been created. The Ministry of Finance can appoint a trustee or managing committee to supervise the general working of the bank. With the appointment of these officials, the members of the bank's administrative and supervisory boards are deprived of their positions.

Managers and responsible officials of reorganised banks have been dismissed in a number of cases, and proceedings have in some cases been taken to obtain compensation.

Regulation of competition and interest rates

In the law of 21st April, 1932, provision was made for the establishment of an Advisory Council (*Poradni sbor: Beirat*) to direct the operations of an Arbitration Committee for Cases of Unfair Competition (*Ustredni smirci organ: Zentral Vergleichsorgan*) formed by government decree in 1928. The constitution and powers of these two organisations were defined in a law of 2nd March, 1933, as amended in 1934 and 1935, and in a government decree of 23rd March, 1933.

The Advisory Council is entrusted with several important duties. It draws up rules governing competition in the interests of good banking conduct and, in particular, details of rates agreements of all kinds ; it can also change or abolish these regulations if it so desires. The government can require the Advisory Council to fix interest rates (within a given period) at an economic level, and to give its opinion on the suitability of the spread between debit and credit rates of interest for particular groups of banks. The regulations drawn up by the Council become binding in law [1] when they have been approved and promulgated by the government, which acts on the recommendations of the Minister of Finance and the other Ministers concerned. If, however, the Council does not fix maximum

[1] They then become known as "rules" (*Soutezni normy: Wettbewerbsnormen des Geldwesens*).

rates for deposits and loans, or if the government does not approve of the regulations submitted, the latter itself can fix these rates if exceptional economic conditions make it desirable, on the recommendation of the Finance Minister. Adequate consideration must be given to differences between the various types of credit institution. The government is also empowered to regulate other interest rates. In both these cases the Advisory Council and, in addition, the Council of the National Bank of Czechoslovakia are to be consulted beforehand.[1] Besides discharging these functions, the Council gives its opinion on all matters connected with credit and banking, either on its own initiative or at the request of the Finance Minister; advises the Courts of reports received in cases of infractions of the rules; observes and assembles details of banking practice; prepares regulations for the carrying out of inspections, and observes whether the inspecting bodies perform their duties efficiently; and finally, organises, in co-operation with the State Statistical Office and the National Bank, the collection of banking and credit statistics.

The Council is composed of a chairman, three deputy chairmen and thirty-five other members. The chairman, vice-chairmen and twenty-seven members are drawn from the membership of the Arbitration Committee. Of the remaining eight members, five are representatives of the Ministries of Finance, Industry, Trade and Commerce, the Interior, Agriculture and Social Welfare, and are appointed by the Minister of Finance; the other three are representatives of the most important branches of industry outside banking. The Council is divided into two sections; the first is a chairman's committee (*Predsednictvo: Präsidium*), which represents the Council and consists of the chairman and his deputies; the second, called the plenary council (*Valne shromazdeni clenu: Vollversammlung*), votes on the motions proposed. In the case of

[1] Interest rates were fixed by government decree in April, 1933, and February, 1936.

motions dealing with the regulation of interest rates, a special committee elected from amongst the members must be set up to examine the proposals before they are submitted to the plenary council; experts may be co-opted, especially when the proposals are concerned with long-term interest rates.

The Arbitration Committee is the executive body of the Advisory Council. It conducts proceedings in respect of complaints against banks for infractions of the regulations established by the Advisory Council and the government. Any bank or person may lodge a complaint before the Committee, which endeavours to bring the parties to an agreement as to the restitution, if any, to be made, the fines to be paid and the suspension of the practices complained of by the bank accused of transgressing the law. If, for any reason, arbitration is impossible, the Committee investigates the case and has power to examine all books and documents, the two parties and their employees personally; such inspection may be carried out by the arbitration tribunal of the Committee or by the National Bank. If the bank accused is found guilty of contravening an agreement in regard to competition, the Committee announces its decision (against which an appeal may be made), advises the local Court to which the relative documents are also sent, and recommends what penalty should be imposed. The penalty may be remitted in certain circumstances, but not if the Committee can show that the guilty party has already disregarded a rule on at least two occasions during the previous two years. This arbitration procedure is, however, not permissible in the case of an infraction of interest rates agreements; this must be dealt with by the local Courts of Justice. The Committee is required to investigate the circumstances of an alleged infraction of the regulations at the request of the Court, and also to state whether in its opinion a given action would constitute infraction. In addition to enforcing the agreements limiting competition, the Committee recommends to the Advisory Council the

introduction, modification or abandonment of regulations, and is entrusted with the duty of instituting and maintaining harmonious relationships between the different groups of banks.

The Committee consists of a chairman, three deputy chairmen, two nominees of the Council of the National Bank and twenty-five other members who represent different groups of banks. The chairman is a representative of the National Bank, while the other members are nominated for a period of three years by the Finance and other Ministers on the recommendation of the central organisation of the groups of banks. The Committee is divided into five sections. A chairman's committee (*Predsednictvo: Präsidium*) co-ordinates the work of the other sections and is the representative body. A technical committee (*Normativm vybor: Normativausschuss*) has the duty of recommending, either on its own initiative or at the request of the Advisory Council, the introduction, modification or abandonment of rules to promote fair competition. An arbitration tribunal (*Smirci senat: Vergleichssenat*), composed of a chairman and two other members, at least one of whom must be acquainted with the law (in the absence of such qualifications, a legal expert must be co-opted), deals with the arbitration procedure outlined above. A register of persons found guilty, and of the rules contravened, is kept. No salary is attached to these appointments. An appeals tribunal (*Dovolaci senat: Berufungssenat*) consists of a chairman and four other members; at least two members must be acquainted with the law; otherwise, legal experts must be called in. The positions are again honorary. The tribunal judges appeals; if it rejects an appeal, it may order the arbitration tribunal to stop the proceedings or to extend them and consider the facts afresh. Finally, there is a plenary council which has, amongst other functions, the duties of issuing regulations regarding the activities of the arbitration and appeals tribunals, giving its views on important matters relating to competition, and

choosing a committee to devise means to ensure that all parts of the banking system work together without friction. Both the Advisory Council and the Committee have their offices in the building of the National Bank.

The power given to the government to determine interest rates should prove a valuable instrument of control, since the fixing of maximum rates for deposits will tend to discourage competition for deposits through the offer of excessive rates, while the imposition of maximum rates for advances will prevent the small borrower from paying disproportionately high rates for his loans.

While, however, it is essential to have some authority to enforce the provisions of the rates agreements, it may be open to question whether the administrative machinery created by the law is not over-elaborate. It is said, however, to work without friction.

Activities of the banks

Under the law as amended in 1932 several classes of business are forbidden or subjected to control. Trade in goods is prohibited, except in so far as it relates to wholesale trade on commission in goods and raw materials for the account of firms in business relationship with the bank, and to the occasional purchase or sale of goods and raw materials for the purpose of recovering money advanced.

Banks are forbidden to transact business with, or to act as intermediaries for, members of the supervisory board and their families; savings deposits or current accounts may, however, be accepted from them. Similar restrictions apply to business with members of the board of directors who have a service agreement with the banks, leading officials and other employees and their respective families. In the case of the last-named persons, certain kinds of cash business may be carried on, and also certain credit transactions, provided that satisfactory guarantees are given and that speculative business is not entered into. Finally, no business transaction, in the profits of

which a member of the board has a share, may be entered into by a bank. Such business mentioned above as may be transacted must be expressly approved beforehand by the supervisory board. A similar authorisation must also be obtained for operations (apart from deposit business) of the bank with members of the board of directors not bound to the bank by service agreements, their attorneys and families, together with enterprises dependent on the bank or on which the bank is dependent. Lastly, no credits in excess of 10 per cent. of the bank's capital and reserves may be granted to any one debtor without the express permission of the supervisory board.

Apart from these restrictions, the banks are free to carry on whatever type of banking business they desire, although the apparent lack of such positive regulations as the proportion of cash to be held against deposits and the form in which investments are to be held may well be belied by the obligation on all joint stock banks to draw up a constitution. This document must be drawn up in accordance with a government order and be approved by the Ministry of Finance, which has the power of ordering changes to be made. It is compiled by the board of directors in agreement with the supervisory board, and governs the business operations of the bank, its administration and the granting of credit. The constitution, which may in some ways be compared with that part of an English bank's memorandum of association which defines the objects of the bank, must be drawn up in such a way that the liquidity of the bank, the observance of the provisions of the law and the bank's good name are in no way endangered. Any neglect or violation of the constitution, which is binding on all members of the bank, may be punished by law.

Credit control

Apart from the control exercised by the National Bank through changes in its discount and lombard rates and

open-market operations, three developments in the sphere of credit control of the commercial banks must be noted.

The government has powers, as mentioned above, to enable it to issue decrees regulating interest rates, after consultation with the Advisory Council and the Council of the National Bank. Maximum rates for deposits and loans were fixed in April, 1933, and again in January, 1936, when a compulsory reduction of interest rates—maximum deposit rates and rates on loans and discounts—was decreed, and was accompanied by a reduction in the discount and advance rates of the National Bank.

The creation of a Czechoslovakian Rediscount and Lombard Institute in 1934 is significant from the point of view of money-market policy rather than from the *standpoint of the control of commercial banks. Its two* main activities are the mobilisation of credit which has become frozen in bonds—mainly government bonds—by granting loans (lombards) against securities and by discounting bills of exchange; and the regulation of the market in government securities. Its funds are derived from a state deposit of Kc.100,000,000, compulsory deposits from banks and insurance companies, and rediscounts at and loans from the National Bank. The Institute has one other function which is important from the point of view of the control of banking. With the special consent of the government the Institute can, if public interests require, liquidate the banks or any other institutions which keep deposits with it.

Finally, an important step in the qualitative as well as quantitative control of credit was taken by the enforcement by a government decree in April, 1936, of a law of April, 1920, which charged the National Bank with the duty of establishing a control of commercial credits :—" the Bank is required in the interests of orderly banking to set up a control of commercial credits and to administer it in such a way that a misuse of credits becomes virtually impossible. The Bank is empowered to demand information and reports." The National Bank has, in accordance

with the terms of the decree, set up a special department to which all credits of Kc.100,000 and over granted to any one debtor must be reported. The department must keep a list of all such debtors and a special register of debtors who have credits running with two or more banks. Information may be given to the creditor banks, provided that certain formalities have been complied with.

Conclusion

Although the law does not appear to be so definitely restrictive in Czechoslovakia as in some other countries, many of the restrictions found elsewhere exist in some form or another; for example, those with regard to large loans to a single customer, loans to directors and officials, restrictions on the number of outside appointments to be held by directors, capital and reserves, the formation of new banks and establishment of branches, the qualifications demanded of directors, and so on. A provision which is not found elsewhere is that relating to the terms of employment of the senior officials of the banks, while the formation of an organisation under government supervision to control conditions of competition between banks and the direct fixing of interest rates by the government are also comparatively rare. The Guarantee Funds, which have received so much attention in the preliminary part of this chapter, have also no counterpart except in the Federal Deposit Insurance Corporation of the United States. From the point of view of control, they play a less important part than the F.D.I.C., which exercises a continuous supervision over the banks which insure with it, although it must not be forgotten that in the 1932 legislation banks receiving assistance from these two Funds and from other public sources were subjected to a far-reaching degree of control and would presumably be so subjected again, should another banking crisis occur.

The chief characteristic of the Czechoslovakian law would appear to be the emphasis placed on internal control, for positive regulations such as the maintenance of

definite ratios between deposit liabilities and cash reserves and the investment of funds in certain types of assets are, with the exception of the requirements with regard to capital and reserves, entirely absent. Provisions for external control are, however, far from slight, as a mere recital of the organs of control shows :—the committees of the Guarantee Funds, the Ministry of Finance, the State Commissioners, the Auditing Association with its Inspection Department, the National Bank with its Credit Department, the Advisory Council and the Arbitration Committee. The Czechoslovakian banking system is thus subjected to a considerable degree of external supervision, for which, ultimately, the Ministry of Finance is made responsible.

DENMARK

DENMARK

Introduction

THE first Danish bank was established as early as 1736 under the name of Kjøbenhavns Assignations-Vexel-og Laanebank. On the separation of Norway and Denmark in 1814 both countries formed their own state banks; Norway the Norges Bank in 1816; Denmark the Nationalbank i Kjøbenhavn in 1818.

The growth of commercial banking was, however, slow. The first joint stock commercial bank in Denmark was not formed until 1846, although a number of private bankers were carrying on business before this date. The general prosperity of the early fifties stimulated the formation of banks, but a marked development of the banking system came only after 1870, and even at the close of the century, banking resources were still small.

In 1913 there were 144 banks, whose capital and reserve funds aggregated 265 million kroner. By the end of 1921 197 banks were in operation, the capital and reserves of which totalled 603 million kroner. In the later years of the War the dangers of undue expansion were recognised and it was decided to subject the banking system to some measure of legal control. On 4th October, 1919, a Banking Act was passed which, for the first time, laid special obligations on banks apart from the general requirements of joint stock company law.

Hardly had this legislation come into operation when the full force of the international crisis of 1920 and 1921 made itself felt in the Danish banking system. The banks were vulnerable both on account of their large

industrial participations and on account of extensive loans on securities, and the succeeding years saw an unprecedented number of bank failures. A number of important banks had to liquidate, including Kjøbenhavns Diskontobank og Revisionsbank, Kjøbenhavns Privat Laanebank and Den Danske Andelsbank, while the biggest bank in the country, Den Danske Landmandsbank, was only saved by repeated intervention by the government at a cost to the state of well over 100 million kroner.

This experience led to a demand for more stringent control, and on 15th April, 1930, a new Banking Act was passed which, repealing the 1919 act, forms the basis for the present system of regulation. The new act is similar in scope to the 1919 act, and the chief differences, which will be noted within the following pages, are of degree rather than of kind.

Formation

In contrast to the legislation in Norway and Sweden, the Banking Acts of 1919 and 1930 give the authorities no discretionary powers to refuse to permit the formation of a new bank, to control the number of branches opened or to order the suspension of an existing bank. The duties of the Ministry of Commerce in these fields are confined to seeing that the articles of association are in accordance with law, and the position is similar to that obtaining in England, where the Registrar of Companies is concerned only with the technical details of registration and has regard neither for the standing of the persons forming the company nor for the desirability or otherwise of its formation. This omission in the Danish legislation is the more noteworthy as the inflation in the War years had seen a number of new banks spring up under managements that were not always prudent. Thus at the end of 1921 there were 58 banks in existence which had been formed during the years 1916–20; by the end of 1935, 25 of these had either failed or been absorbed by other institutions, an indication perhaps of the scope for control in boom conditions.

Amalgamation

Although the formation of new banks is not controlled, an amalgamation with another bank or savings bank or the acquisition of the business of a bank or savings bank requires the permission of the Minister of Commerce. Foreign banks may establish branches only with permission, although in fact no such permits have been given. During the earlier years of the post-War period the number of banks was reduced mainly by failures; more recently, however, there has been a tendency on the part of the larger Copenhagen institutions to absorb smaller institutions. For example, in 1935 two banks went into liquidation and six banks were absorbed, four by Privatbanken i Kjøbenhavn, one by Den Danske Landmandsbank and one by a smaller provincial institution.

Permitted activities

Apart from savings banks, which are subject to special regulations, banking may be carried on only by a company organised under the Joint Stock Companies Act with limited liability, and such companies alone have the right and obligation of using the word "bank" in their name and description. The name must not give the impression that the bank is the central bank and branches must indicate clearly their subsidiary character. No other business may be carried on in addition to that of banking, which is defined as including "receiving deposits, granting loans, receiving valuables for safe custody, dealing in coined and uncoined gold and silver, in money and token money, credit instruments and securities, collecting debts, effecting payments, giving guarantees and, according to circumstances, co-operating in the establishment of trading undertakings". In cases of doubt as to whether or not a company falls within the scope of the act, the Minister of Commerce is empowered to give a ruling.

Attempts to segregate deposit banking from other financial activities are common features of banking

legislation. The specific inclusion of a provision for "co-operating in the formation of trading undertakings" is therefore worth comment. In Denmark the commercial banks have always played a large part in the industrial expansion of the country. They have never confined their activities to the financing of current trade and their loans against securities have always been large. In the absence of specialised investment banking houses such as exist in more developed capital markets, they have had to undertake the issue and marketing of shares and bonds of industrial concerns. Other countries which previously had such a mixed banking system have taken steps during recent years to prevent the commercial banks from becoming too deeply involved in long-term finance to industry. In Sweden, for example, following the restrictions of the Bank Act of 1933, a special institution was formed to grant medium- and long-term industrial credits. In Denmark the authorities evidently deem that the situation is not yet ripe for more than moderate restrictions.

Capital

The minimum capital was fixed by the 1919 act at 200,000 kroner, of which at least 25 per cent. had to be paid up before the bank could commence business, while the remaining 75 per cent. had to be paid within three years in instalments of at least 25 per cent. a year. The experience of the next ten years suggested that these requirements might be tightened up with advantage. The 1930 act accordingly increased the minimum capital to 300,000 kroner, made 50 per cent. payable immediately and the remainder within twelve months. Banks which in 1930 were under the limit had to increase their capital before the end of 1934, but with the special permission of the Ministry of Commerce the period could be extended to 1939. At the end of 1935 there were 18 banks with a share capital under 200,000 kroner and 50 more with a share capital under 300,000 kroner, the total number

in operation being 168. Thus over a third in number of the banks have a share capital below the official minimum, and although these banks control an insignificant proportion of the deposits of the whole country, it does not seem that legislation has been particularly successful on this point.

In any case, to fix a minimum capital is not enough, for in a banking system having large and small units, capital must be related to the size of the business. The Banking Act of 1919 accordingly provided that the paid-up capital and surplus must be at least 10 per cent. of total liabilities. The act of 1930 maintained the basic 10 per cent. ratio, but required liabilities under guarantee to be included in liabilities and restricted them to 75 per cent. of the bank's capital. If for any reason these ratios are not maintained, the bank is allowed six months in which to rectify the position, although in special cases the Minister of Commerce may grant a longer respite.

An examination of the balance sheets of the Danish banks would seem to indicate that in quite a considerable number of cases the capital is barely enough to fulfil this requirement, and it might not unfairly be inferred that in the absence of any legal minimum, capital would in many cases be lower than it is now.

History can show many examples of banks which might have avoided causing losses to their depositors as well as to their shareholders if action had been taken at an early stage in a crisis. The Bank Act of 1930 provides two remedies. If the board of directors or the managers or auditors have reason to believe that more than 35 per cent. of a bank's capital is lost, the matter has to be reported to the Bank Inspector immediately. This having been done, the authorities are made aware of possible weaknesses in the banking structure and are able to frame their policy accordingly. If greater losses have been incurred, estimated either by the board of directors or the Inspector to amount to more than 50 per cent. of the bank's capital, a general meeting must be

called immediately. At this meeting the capital has to be reduced to the amount at which it is represented by assets and fresh capital provided sufficient to raise the capital to 50 per cent. of its former amount—subject, of course, to the minimum capital requirements already mentioned. If the additional capital cannot be raised, the bank must liquidate, unless it is specially exempted by the Minister of Commerce.

In practice it must be difficult to determine when a debt becomes "bad" and to distinguish between temporary depreciation and permanent loss, and there may well be a difference of opinion in particular cases as to whether or not a certain proportion of a bank's capital has been "lost". In spite of these difficulties the rule on the whole should tend to stop banking failures in their early stages and afford depositors real protection.

Management

Regulations concerning management are few. Apart from the general requirements of Danish company law, banks must have a board of directors and a board of managers. The board of directors consists of at least three shareholders, and where the number is only three, there must be in addition an alternate director. The board of managers consists of one or more managers. As in Sweden since the beginning of 1934, instructions approved by the Bank Inspector have to be laid down by the board of directors defining the powers of the managers to grant loans without reference to the board—except in cases where such rules have been embodied in the articles of association. Directors and managers (including managers of branches of foreign banks operating in Denmark) must be Danish subjects, although this rule may be waived by the Ministry of Commerce.

Besides the directors and managers there is a board of representatives whose duties, set out in detail in the articles of association, are to watch the interests of depositors and shareholders. Members of the board of representatives

must be Danish subjects, and they have in general the same responsibility at law as directors.

Transactions between a bank and its directors or members of the board of representatives are not prohibited, but the board of directors and the managers must examine them carefully to see that they are justifiable operations and that the bank is adequately secured. The same conditions apply to transactions with companies, members of whose boards of directors or representatives are directors or managers of the bank, to transactions with persons related directly to managers, or with companies of which such persons are managers. Managers, branch managers and other bank officials must not engage in speculative operations, nor carry on nor participate in any other trading activity. Managers of banks with a share capital of 500,000 kroner or less and managers of branches with deposits of less than 5 million kroner may, however, have outside interests with the approval of a two-thirds majority of the board of directors. Managers of larger banks and branches may be members of the board of directors or board of representatives of trading companies if their appointment is approved by a two-thirds majority of the bank's directors.

Without the express sanction of the board of directors managers may not borrow from the bank, obtain the guarantee of the bank for loans, or themselves guarantee debts due to the bank. Such transactions are absolutely forbidden for auditors.

The accountant and cashier of a bank may not be the same person, and in banks with a share capital of more than 500,000 kroner these posts cannot be combined with that of member of the board of directors, board of managers or board of representatives. Similarly they cannot be combined with the position of branch manager in branches of which the deposits are over 5 million kroner.

At least two signatures are required to bind the bank and the names of the persons authorised to sign must be filed with the registrar of joint stock companies.

Reserve ratios

The 1919 act made only one stipulation regarding cash reserves. Banks were required to hold cash and readily marketable bills and securities to the extent of at least 15 per cent. of demand deposits (as defined below). It will be noted that the ratio applied only to demand liabilities, which in 1919 accounted for about 65 per cent. of total deposits.

The experience of the next few years was one of depression and banking failures, and it is not surprising that steps were taken to increase the cash reserves. It is the moderation rather than the strictness of the regulations contained in the 1930 act that calls for comment.

There are now three ratios. There is firstly a ratio of cash to total liabilities. Under the Bank Act of 1919 " cash " had been defined as demand deposits with the Nationalbank, which was felt by the larger Copenhagen banks to be a hardship, for they had been accustomed to holding the reserve balances of the smaller banks. The draft legislation of 1925–26 therefore provided that banks other than the central bank could be authorised by the Ministry of Finance to hold cash reserves. This concession did not satisfy the big banks and the clause was accordingly altered. In the Bank Act, as passed, cash is defined as net balances payable on demand with domestic and foreign banks and balances with the post office clearing account.[1] Net balances does not mean the amount by which a bank's total demand deposits with its correspondent banks exceeds the total amount it owes to them, but is reckoned as the total of its net demand balances with individual banks.

The ratio of cash, as defined above, to total liabilities depends on the size of a bank's share capital. In banks with a share capital of 20 million kroner or more, cash must amount to at least 3 per cent. of liabilities ; if the capital is below 20 million kroner but above 5 million

[1] Postgirokonto.

kroner, the minimum is 2 per cent., and if the capital is below 5 million kroner, the minimum is 1 per cent. This principle of requiring a smaller cash ratio for smaller banks is in direct contrast to that adopted by the Swedish legislature, which requires a larger cash ratio for smaller institutions. The Danish system can be defended on the grounds that there is a tendency for the smaller banks to hold part of their cash reserves in the form of deposits with other banks—a practice which is also recognised in the United States, where, for example, reserve city banks are required to hold larger cash reserves than out-of-town banks.

There are at present three banks with a share capital of 20 million kroner or over, viz. Privatbanken i Kjøbenhavn A/S, Den Danske Landmandsbank A/S and A/S Kjøbenshavns Handelsbank. Deposits of commercial and savings banks with these institutions amounted at 30th June, 1937, to 89 million kroner, out of total inter-bank deposits for the whole system of 123 million kroner. Deposits of the " big three " Copenhagen banks with other banks amounted to 9 million kroner, while the deposits of the rest of the banks with each other amounted to 26 million kroner. Although precise calculation is impossible owing to the inclusion of the savings banks in these figures, the important part played by the " big three " banks as holders of the country's cash reserves is clearly indicated. These banks appear to recognise their responsibilities, for they keep cash reserves far in excess of the limits laid down by law, and at 30th June, 1937, their cash reserves amounted to 9 per cent. of total liabilities, compared with a statutory minimum of 3 per cent.

There is, secondly, a ratio of liquid assets to demand deposits, which is fixed at 15 per cent., as under the Bank Act of 1919. Liquid assets are defined as consisting of cash, readily realisable securities and credit instruments not serving as collateral for loans. During the discussion of the draft Bank Act this requirement was criticised on the grounds of the ambiguity

of the definition of "liquid assets". The Minister of Finance maintained, however, that it was impossible to lay down hard-and-fast rules which would always be valid, and that the question of eligibility was a matter of judgment rather than definition. He said that the term "credit instrument" could include a variety of types of indebtedness, provided that they were safe, readily realisable and unpledged. When asked, for example, whether credit association bonds should be made a basis for bank credit, he replied that such bonds might be used within reasonable limits, but that reserves should consist primarily of readily realisable commercial claims. He added that it was a question which the Inspector of Banks would have to decide in each individual case, bearing in mind the general position of the bank and the distribution of its assets. The question of the eligibility of bills for inclusion as "liquid assets" also attracted attention. The draft bill of 1926–27 contained the words "including bills" after the expression "credit instruments". These words were removed from the final draft on the grounds that their inclusion might have created the impression that any bills might be included. In practice, eligibility for rediscount at the National Bank is taken as a criterion.

Demand deposits are defined as those payable on demand or at shorter notice than one month, and include balances on accounts which may only be drawn on within certain limits. On the other hand, deposits fixed for periods longer than one month are not included, even where there is an arrangement whereby they may be drawn on at sight if interest is foregone.

Finally banks must maintain a ratio of at least 10 per cent. of liquid assets to total liabilities, including liabilities under guarantees.

In the event of the cash reserve having to be drawn on, so as to reduce it below the statutory level, the matter must be reported within eight days to the Bank Inspector, who has then to fix a period within which the reserves have to be restored to the statutory level.

Assets

Apart from the requirement that liquid assets must amount to 15 per cent. of demand liabilities, the Bank Act of 1919 made no important rules regarding the proportion of assets of various kinds which a bank might hold. The experience of the next decade, in Denmark and elsewhere, caused a change of attitude which is evidenced in the Bank Act of 1930.

Reference has already been made to the cash ratio. In addition to this requirement, shares owned by a bank may not exceed in the aggregate 50 per cent. of its capital, although with the permission of the Bank Inspector this figure may be exceeded where, for instance, the shares are only held temporarily during a reconstruction. Real estate, or shares in real-estate companies, may not be carried in the books at a value in excess of 20 per cent. of the bank's capital, bank premises being excluded from the provisions of this clause. Where, for its own protection, a bank is compelled to take over shares or real property against which it has made a loan, the Bank Inspector may waive temporarily the application of these ratios. No limitations are imposed on the total amount advanced on shares, although over-investment and a stock-exchange boom may be stimulated as easily by loans on securities by the banking system as by outright purchase.

Maximum individual risk

Where the number of banks is large, as in Denmark, there is a danger that one institution may have too great a stake in the fortunes of a single concern. There are therefore elaborate rules designed to relate the maximum amount due from any one customer to the size of the bank's capital.

A bank's advances to any one customer must not exceed 35 per cent. of its capital—a proportion which is higher than that fixed by banking codes in other countries.

On the unanimous recommendation of the managers, endorsed by a two-thirds majority of the board of directors, the limit may be increased to 50 per cent., information relating thereto being filed with the Bank Inspector. For the purpose of this provision, a group of interlocking companies is regarded as one.

Certain types of advances are excluded from this restriction, such as bankers' credits, loans secured by corresponding deposits with the bank, loans on government bonds and bonds of mortgage banks or credit associations up to 75 per cent. of their market value, and mortgages on real estate up to a certain percentage of their taxable value. The Bank Inspector may allow loans on other securities of a similar type to be excluded.

The 35 per cent. proportion mentioned above includes, however, any shares in the company in question owned by the bank or against which it has advanced money, and these are limited to 15 per cent. of the bank's own capital.

Except with the permission of the Bank Inspector a bank is not entitled to acquire, or accept as security for a loan, with the right of voting, more than 50 per cent. of the share capital or guarantee capital of another bank or savings bank, and in any case full details have to be filed with the Bank Inspector monthly. A bank may not buy or accept its own shares as security to a greater amount than 10 per cent. of its paid-up capital, and details of loans on a bank's own shares have to be filed with the Inspector, and are published regularly. At the end of 1935 only 31 banks out of 168 were shown as owning any of their own shares, and the total balance-sheet value of such shares was only Kr. 289,000.

Audit

A bank's accounts must be audited by at least two auditors appointed by the shareholders in general meeting; one auditor must be a chartered accountant. Incompetent auditors may be dismissed by the Ministry of Commerce, which then nominates a chartered accountant to act until

the next general meeting. An auditor is not allowed to occupy any other post at the bank, to be a member of the board of directors or board of representatives. Relationship, whether by marriage or by lineal ascent or descent with a director, manager, member of the board of representatives, accountant or cashier, is also a bar.

Detailed regulations regarding audit are drawn up by the Minister of Commerce, such regulations covering also control of daily bookkeeping.

Accounts and returns

The usual requirements relating to publication of reports and balance sheets are found also in Danish banking legislation. Monthly statements drawn up in a form prescribed by the Ministry of Commerce are filed with the Bank Inspector, as are the annual report and accounts—the form of which is also prescribed—after they have been adopted by the annual general meeting. The monthly statement drawn up at the end of every three months, together with the annual report and balance sheet, have to be published in at least one newspaper, while in addition the annual accounts have to be published in newspapers circulating wherever the bank has branches. The Ministry of Commerce also requires the banks to furnish the Bank Inspector with other information.

The method of drawing up the balance sheet has had the attention of the legislator, and under the Bank Act of 1930 a standard form of accounts is drawn up by the Minister of Commerce on the proposal of the Bank Inspector. The financial year must be the calendar year. Quoted securities must be taken at the latest buying price, unquoted securities at their estimated value or book cost, whichever is lower. Foreign exchange has to be valued not higher than the closing rate on the day to which the balance sheet relates, real property at cost plus improvements, less depreciation. Goodwill and other intangible assets must be written off by at least one-third of the original amount annually. Unless the capital

amounts to 15 per cent. of the total liabilities of the bank (including liability under guarantee), at least 20 per cent. of such annual profits as are not required to cover any losses brought forward from previous years have to be placed to reserve. Dividends during the first three years are limited to 6 per cent., and the share in profits accruing to directors and managers to 2 per cent. of the share capital.

It might also be mentioned here that if a bank receives deposits withdrawable against presentation of a pass-book, the pass-book must, when first issued, contain a copy of the articles of association of the bank. It must also be stated conspicuously in the pass-book that the articles of association, the three latest monthly statements and the latest annual accounts of the bank will be shown to any depositor on application. If deposits can be withdrawn without presentation of the pass-book, each page of it must state that the balance shown in the pass-book is no evidence of the amount standing to the credit of the depositor.

Inspectorate

Government supervision is through a Bank Inspector, appointed by the Crown, and in his hands is the enforcement of the Bank Act. Banks have the right to appeal against a decision of the Inspector to the Minister of Commerce, who is empowered to demand prosecution in the case of fraud or irregularities on the part of managers or directors and to levy fines for failure or delay in meeting the requirements of law.

It is the duty of the Inspector to make regular examinations, in accordance with regulations laid down by the Minister of Commerce, and the banks are bound to give him all the information he requires for this purpose.

The Inspector and his staff must treat any information they obtain in the course of their duties as confidential, but the Inspector may disclose to the banks concerned that a debtor has incurred liabilities to several institutions.

In order to maintain the impartiality of the inspection the Inspector may not be a partner in any business or a member of the board of representatives or board of directors of any trading company, and he is forbidden to take paid employment in any such business. Speculative transactions are forbidden to the Inspector and the members of his staff. To borrow from a bank or guarantee a bank loan for a third party the Inspector must obtain the permission of the Minister of Commerce: other members of the staff have to apply to the Inspector.

The expenses of supervision are covered by annual contributions from the banks, based on their total outside liabilities, as shown by their latest balance sheets.

The Bank Inspector submits to the Minister of Commerce an annual report containing the balance sheet and profit-and-loss account of each bank, together with combined accounts for the whole system.

Conclusion

Banking control had been discussed in Denmark for some years before legislation was actually introduced, and here, as in other countries, it was the over-expansion of banking facilities engendered by the boom conditions of the years 1917 to 1919 which provided the occasion for its introduction. The bank failures of 1922 and 1923 drew public attention to the problem, and the Bank Act of 1930 was designed to remedy the abuses which had been disclosed.

There is little doubt but that the system has worked well. Banking standards have been raised, although legal requirements are in some ways less exacting than those in force in other Scandinavian countries.

GERMANY

GERMANY

The development of commercial banking

JOINT STOCK BANKING in Germany originated with the foundation of the Schaaffhausen'scher Bankverein in 1848. This bank, which did not issue notes, and resembled the Crédit Mobilier of France, served as a model for several other banks established a few years later. The Darmstädter Bank was established in 1853, the Berliner Handelsgesellschaft and the Discontogesellschaft followed in 1856, while several other banks were founded in various parts of Germany in that decade. In the first half of the nineteenth century German industry was suffering from a dearth of capital. It was not that capital resources were non-existent, but rather that no adequate facilities existed to direct the stream of savings into the channels of industrial finance. The banks were founded with the express object of promoting industrial development by establishing companies and equipping them with capital. But although the promotion of companies was placed in the foreground, it was not the only activity envisaged, since the banks also wished to carry on short-term finance. It was intended not that they should hold permanently the shares of the companies they founded, but that the shares should be passed on in due course to the investing public. The necessity of avoiding the immobilisation of resources, especially of those received from the public, was early recognised, although, in point of fact, the banks did not at first encourage the acceptance of deposits, as they preferred to rely on their own resources. After a short boom period

in the fifties, progress was slow until the seventies, when several joint stock banks were formed, amongst them the Deutsche Bank and the Dresdner Bank; after a period of prosperity from 1870–73, a recession set in, several banks failed, and an era of relative stagnation ensued.

In the last quarter of the century, important changes took place in the character of banking business. The Deutsche Bank had, from its inception, developed along distinctive lines, by specialising in the financing of foreign trade. In order to obtain more funds for this purpose, it sought deposits from the public. After a somewhat inauspicious start, the Deutsche Bank forged ahead when the world trade boom of 1895 made the financing of foreign trade more profitable. It was at this time that "mixed banking", typical of German banking evolution, emerged. Its characteristic was the combination of British deposit banking with the long-term finance associated with the French *banques d'affaires*. While in some cases completely new undertakings were established by the banks (the shares ultimately being sold to the public), yet these functions were often left to specialised banking subsidiaries. The banks occupied themselves mainly with the transformation into companies of already existing private businesses with which they had already had extensive dealings, or with raising additional capital for such firms. A characteristic feature of mixed banking was for banks to permit capital developments to take place in the first instance by overdrafts on current account, these being repaid later by the issue of securities. Provided that the securities could be disposed of easily, this method of finance did not lead to any serious difficulties and in the pre-War period it worked, on the whole, very well. The successful continuance of this type of industrial finance was dependent on two main factors: the policy, adopted by the bigger banks, of maintaining a high ratio between capital and reserves, and liabilities; and the distribution of risk by carrying on business as far as possible with all branches of trade and industry.

Representation on the boards of the companies in which the banks were interested enabled them to keep in close touch with all developments.

Structural changes in the banking system also took place. Although amalgamations did occur, the concentration movement that was characteristic of the last part of the nineteenth century and of the beginning of the twentieth manifested itself mainly in a geographical concentration of financial resources in Berlin, the big provincial institutions acquiring branches in the capital, while the large Berlin banks frequently gained control over provincial banks.[1] Branch banking, in the English sense, had not developed to any great extent. Since the War, however, the concentration process has been much accelerated, many amalgamations having taken place both between Berlin banks and provincial banks, and between the big Berlin banks themselves.

In the years before the War the Reichsbank (founded in 1876) was endeavouring to evolve a satisfactory credit policy. The effectiveness of control through alterations in its discount rate was much reduced by the rapid growth of a private discount market. This was clearly shown in the failure of the Reichsbank to avert the crisis of 1907–8, when, for some considerable time, its discount rate had been out of touch with the private discount rate. In this instance, as the cash balances of the banks were low, the Reichsbank was compelled to rediscount on a very large scale. To overcome this ineffectiveness of discount-rate policy, a mild form of open-market operations was adopted, whereby holdings of treasury bills were sold or permitted to mature when such action was deemed necessary. But the central bank still exercised only a limited control over the banks. Further measures were, therefore, introduced to influence directly the credit policies of the banks. After the 1907–8 crisis, the commercial banks agreed to publish balance sheets in a prescribed form every other month and

[1] In 1913 the nine big Berlin banks controlled directly or indirectly some 80 per cent. of the resources of all German joint stock banks.

to maintain increased cash reserves with the Reichsbank. Some progress was being made in the latter direction when the outbreak of war occurred.

The inflation and post-inflation period

The effects on the banking system of the War and of the subsequent period of inflation were profound. The following figures show the extent to which the capital and reserves of the banks were reduced in this period.

Representative Group of Banks [1]	Capital (Millions of Gold Marks)	Published Reserves (Millions of Gold Marks)
At end of 1913	2998	741
At 1st January, 1924 . . .	792	238

There was, in the same period, a decline in the gold value of the deposits of the large Berlin banks from 4852 million gold marks to 1058 million gold marks. The liquidity of the banks also suffered in this period. In the early days of stabilisation, the banks still endeavoured to rediscount large amounts with the Reichsbank, until a system of credit rationing was introduced. In these years, too, competition from official banks of various kinds and from savings banks became much more severe, and this led to an undesirable extension of credit facilities.

The years following 1924 witnessed the economic rehabilitation of Germany, the phenomenon of the great inflows of foreign capital, and the credit crisis of 1931, which was directly responsible for the elaborate banking legislation passed in 1934.

After the stabilisation in 1924, the whole German economy stood in desperate need of capital. The losses sustained in the Great War and the immediate post-War reconstruction of industry had already absorbed what capital there was left after 1918, while the inflation, which

[1] Franz Grüger, *Wirkungen des Krieges und der Kriegsfolgen* (Evidence of the Banking Inquiry).

began in 1922, caused all capital resources to be drawn upon, and at the same time annihilated liquid resources. Not only was capital scarce, but the need for it was great, both to pay reparations and to rationalise German industry in order to secure for it a share of the world's trade. The demand for capital was met in two ways: first by an increase in domestic savings amounting probably to some RM. 30 billion; [1] secondly, by an influx of foreign loans.

The import of capital which began with the flotation of the Dawes Loan in 1924 took the form of both long- and short-term loans. From 1924 to 1929 there was a fairly steady inflow of long-term loans, especially from the U.S.A. After 1929 conditions changed in the American capital market and the stream of long-term capital was cut off. The Young Plan partly reassured investors, and for a short time capital flowed into Germany again, but only to cease abruptly.

After the stabilisation of the mark, there was an immediate inflow of short-term funds. In 1925 and 1926 only moderate inflows took place (there was even a withdrawal of funds in 1926), but in 1927 short-term money entered Germany at the rate of some one-and-a-half milliard reichsmarks a year. The peak was reached in 1929. Withdrawals took place in the same year, but after the Young Plan was approved, fresh loans were obtained. The results of the elections of 1930, however, caused further withdrawals, and from then onwards short-term capital was continuously recalled, until the events of 1931 caused immense amounts to be withdrawn.

The banks were not concerned to any great extent with long-term debts, but accounted in 1932 [2] for 50 per cent. of the short-term debt, most of which was due to commercial banks abroad. The loans were represented mainly by deposits in the big Berlin banks (it was estimated that

[1] Dr. Tewaag, *Die Zerrüttung des Geld- und Kapitalmarktes* (Evidence of the Banking Inquiry).

[2] Report of the Bankers' (Wiggin) Committee on the Credit Situation in Germany.

foreign deposits constituted some 44 per cent. of total deposits in 1929 as compared with a figure of 25 per cent. in 1926).[1] Against this liability German banks held deposits in foreign currencies to the extent of one milliard marks (part of which was earmarked against acceptance credits), and also various foreign securities. They also endeavoured to cover their commitments by issuing dollar bonds in New York. Even allowing for the foreign exchange holdings of the Reichsbank, however, foreign liabilities always exceeded total foreign assets by a very considerable sum.

The problem of meeting their liabilities abroad was further complicated by the fact that the banks had lent their short-term funds, most of which fell due to be repaid within three months, to industry and trade on current account (especially after 1927), relying on their ability to float loans to obtain repayment. When the capital market failed to absorb new issues, the banks found that a considerable part of their foreign short-term deposits had become frozen in long-term advances. Moreover, a fall in the proportion of the banks' own resources to total liabilities had taken place, the proportion of capital and reserves to deposit liabilities for the five big Berlin banks falling from 32 per cent. in 1913 to 6·6 per cent. in 1930. Cash and secondary reserves fell likewise to 3·5 per cent., while holdings of bills and non-interest-bearing treasury bills amounted to only 22 per cent. of total deposits.

The position of the banks was further weakened by competition from public banks. Space does not permit a description of the various public banks in Germany, but it may be mentioned that serious overlapping of functions existed between the joint stock banks and certain types of public banking institution, more particularly the state banks, and the savings and municipal banks with their central organisations, the Girozentralen. These banks extended their activities into general bank-

[1] P. Barrett Whale, *Joint Stock Banking in Germany*.

ing business and made long-term advances to industry, often on capital borrowed from abroad.

The question of the investment policy that should have been adopted by the banks to meet the exceptional liabilities imposed by an immense short-term debt to foreign institutions raises problems of fundamental importance. The only policy that might have protected the banks against a sudden withdrawal of short-term foreign credits was a 100 per cent. cover in foreign exchange. This would have been impossible, although the banks, as related above, did attempt to provide a hedge against withdrawals by holding balances abroad and by the issue of dollar bonds. They also endeavoured to make loans to industry in terms of foreign currencies. The deposits of the banks might, of course, have been invested to a far greater extent than they were in liquid assets, as opposed to semi-permanent advances to industry, but unless the exchange reserves of the Reichsbank had been sufficient to cover the total foreign short-term liabilities of the banks, the solvency of the credit system as a whole, as contrasted with the solvency of its individual members, could still not have been secured. The banks might, on the other hand, have lent on a much larger scale to industries engaged in production for export, with the object of creating an export surplus, and have exercised more prudence in lending to large customers without investigating their financial positions thoroughly. Several banks, moreover, neglected the precedent, established in pre-War days, of spreading risks, and became, as a result, unduly dependent on the fortunes of particular firms or industries.

Credit control since 1924

The technical means at the disposal of the Reichsbank for the control of credit were, after its reconstitution in 1924, four in number: discount rate, rationing of credit, direct action on the banks and operations carried out by the Golddiskontbank.

The Reichsbank in its discount-rate policy was continuously faced with the difficulty that if it raised its rate to discourage speculation and the internal expansion of credit, foreign short-term money immediately flowed in and made the money market very liquid; on the other hand, if it lowered its rate to discourage the inflow of funds, the banks found it profitable to rediscount or borrow from the central bank. Control of the money market was also rendered difficult for the first few years following stabilisation by the independent action in the money market of public institutions such as the State Railway and the Post Office, which controlled large surplus funds.

The Golddiskontbank was used by the Reichsbank to take surplus funds off the market and to transfer them as far as possible to the long-term capital market, in order to reduce the discrepancy that existed between long-term and short-term rates of interest.

The Reichsbank, handicapped to some extent by its inability to carry out open-market operations (these operations were prohibited in the law governing the Reichsbank), had recourse at various times to the rationing of credit (for example, April, 1924, the spring of 1929 and July, 1931), and also to a policy of direct action on the banks (on the occasion of "Black Friday", May, 1927, when the banks were forced to reduce their stock-exchange loans). On the whole, the powers of the Reichsbank were probably sufficient, if they had been used ruthlessly enough, to exercise a considerable degree of control over the banks.

It was not until June, 1931, that the Reichsbank raised its discount rate to 7 per cent. (after it had lost RM.1000 millions in gold and foreign exchange in two weeks); it was not raised to a crisis level until 15th July, 1931, when it was altered to 10 per cent. after the reserve ratio had fallen to below 40 per cent. and the banks had been closed for two days. Credit rationing was applied to a moderate degree only at this time, in order to enable the

banks to meet the increased demand for cash from domestic and foreign creditors. On 1st August, to prevent the collapse of the mark, the discount rate was raised to 15 per cent. and the lombard rate to 20 per cent., while the foreign-exchange market was also rigidly controlled. Large credits were, in addition, granted by foreign central banks, but were rapidly used up. After the passing of the crisis, the Reichsbank reduced its discount and lombard rates. With the freezing of foreign balances, the conclusion of standstill agreements and the impossibility of obtaining foreign credits, the Reichsbank no longer regulated its discount policy with a view to conditions in foreign money centres, but based its actions on domestic considerations alone. It may be noted here that by an alteration in October, 1933, of the law regulating the Reichsbank, greater freedom was granted to the bank, in particular by allowing it to count, as cover for the note issue, securities acquired on the market or held as collateral against daily maturing loans. This meant that the Reichsbank could issue notes against securities furnished by the Reich and help to finance the projects of the new government. Since 1933 the Reichsbank's policy has been to regulate and support, as far as possible, the market for government loans and other long-term loans and to finance the various "work creation" projects by taking over from the banks the bills issued for that purpose.

The crisis of 1931 : reorganisation

The withdrawal of foreign short-term funds from Germany began on a large scale in September, 1930, and increased rapidly during 1931, especially after the failure of the Creditanstalt in Austria in May. The withdrawals of the external creditors were accompanied in the later stages by domestic runs. In June and July, 1931, the crisis reached its peak. The financial difficulties of the "Nordwolle" and other important firms directed suspicions against at least one of the big German banks,

and on 13th July the Darmstädter und Nationalbank closed its doors, the stock exchanges were shut and a general banking moratorium proclaimed. The government was forced to intervene by guaranteeing the obligations of the Darmstädter und Nationalbank, by giving assistance to the Dresdner Bank, by bringing about the amalgamation of the Saxon State Bank and the Allgemeine Deutsche Creditanstalt (Adca) of Leipzig and by helping in the reorganisation of the Schroeder Bank in Bremen. The Deutsche Bank was helped by the purchase of its shares by the Golddiskontbank. In addition, the government assisted in the foundation of special emergency institutions such as the Akzept- und Garantiebank, the Diskont Cie., the Deutsche Industriefinanzierungsinstitut A.G. (Finag) and the Tilgungskasse für gewerbliche Kredite (Tilka).

A thoroughgoing reconstruction of the big banks became necessary. The Darmstädter und Nationalbank was amalgamated with the Dresdner Bank, the Commerz- und Privat-Bank with the Barmer Bank-Verein of Düsseldorf and the Adca with the Saxon State Bank. Most of the banks had to write down their capital and reserves and build up their capital again with the help of the government and the Golddiskontbank. By the end of 1933 the paid-up capital of the big Berlin banks had been reduced to 442 million reichsmarks.[1] Only the Berliner Handelsgesellschaft and the Reichs-Kredit-Gesellschaft avoided writing down capital. The significant fact emerges, however, that at the end of the reorganisation the government was the largest shareholder in the commercial banks. The state was in control of the new Dresdner Bank and the Commerz- und Privat-Bank (it was intended that the government's shares should be sold when circumstances permitted) and was already directly or indirectly interested in such institutions as the Reichs-Kredit-Gesellschaft, while the Golddiskontbank was a large shareholder in the

[1] *Memorandum on Commercial Banks, 1925–1933*, p. 118. League of Nations.

Deutsche Bank.[1] The Berliner Handelsgesellschaft was the only important bank not subjected to some degree of public ownership.

The government, being forced to support the banking system to this extent and being desirous of devising means for preventing the recurrence of similar crises in the future, decided to establish some measure of public control over the banks. Accordingly, on 19th September, 1931, an Emergency Decree[2] was passed establishing a Banking Committee which was to work in the closest co-operation with the Reichsbank, and appointing a State Commissioner for Banking as the executive officer of the Committee. As the constitution and functions of this banking control were incorporated in a modified form in the Banking Act of 1934, they must be examined in some detail. The Committee consisted of the President of the Reichsbank as chairman, another member of the Reichsbank Directorate, the Secretary of State of the Ministry of Finance, the Secretary of State of the Ministry of Economics and the State Commissioner for Banking. The function of the Committee was the framing of policy, that of the Commissioner its execution.

The powers of the Commissioner fell into two main categories :—

(1) He was given powers of a general and comprehensive nature. He was to watch over the banking and credit situation and to control banking policy in a general sense in the interests of the entire German economy.

(2) He was given certain specific powers of control and the right to demand information. He was empowered, for example, to require explanations of balance sheets, etc. ; to order inspections ; to take

[1] It was estimated in 1932 that the state held 50 per cent. of the capital of the big commercial banks and the Golddiskontbank another 14 per cent.

[2] Verordnung des Reichspräsidenten über Aktienrecht und Bankenaufsicht und über eine Steueramnestie.

> part in general meetings of shareholders and in meetings of boards of directors ; to have the right of speech at meetings and to require the publication or submission of resolutions.

The Commissioner's powers were implemented by the right to take legal action and to impose fines.

The provisions of the decree extended only to private credit businesses ; the Reichsbank, the Golddiskontbank, the four private note-issuing banks and the various classes of public banks were exempted.

From the point of view of banking control, however, this scheme of supervision was hardly given a fair chance. The Commissioner, in his three years of office, was forced to devote most of his time to the urgent necessities of reconstruction and reform, and regulation had to be more or less neglected in favour of more pressing tasks. The Commissioner collaborated, for example, in the preparation of the plans for the amalgamation of certain large banks ; in measures of reform for co-operative credit associations and local banks ; in some aspects of reform in industrial firms and in the creation of two institutions to help the banks to redeem their frozen debts—the Deutsche Industriefinanzierungsinstitut A.G. and the Tilgungskasse. He also introduced a useful reform by requiring all banks and bankers to submit to an audit of their books by an association called the Verein für Depotprüfung.

The Commissioner's powers were later extended by an Emergency Decree [1] of 8th December, 1931, which enabled him to enforce uniformity in regard to debit and credit rates of interest and conditions of competition. The provisions of this decree were embodied in the Banking Act, as will be seen later.

The advent of National Socialism

On the advent of National Socialism to power in Germany, the banking situation was thus still far from being

[1] Notverordnung vom 8. Dez. zur Regelun der Verhältnisse auf dem Geldmarkt.

satisfactory. The system of supervision had still not proved itself. Many faults in the structure of the banking organism still remained. The problem of the employment of short-term money for long-term investment remained unsolved, and the abnormal conditions in the capital market alleged to come from this were unchanged. Cash reserves were still dangerously low. The control of the Reichsbank over the banks was still ineffective in normal times, owing partly, at least, to the absence of legal or customary rules governing the ratios of liquid assets to liabilities and requiring the commercial banks to maintain deposits with the central bank. There were still too many banks and an incomplete division of functions amongst them. The information given in balance sheets and profit-and-loss accounts was inadequate. Finally, the banking system was still largely dependent on state support.

The National Socialist Government soon found it expedient to appoint a Commission to investigate the banking situation and to make recommendations. Not only was such an inquiry necessary from a technical standpoint, but it was also imperative that public opinion should be satisfied that an attempt was being made to put some of the National Socialist ideas on credit and banking into practice.

First and foremost, the National Socialists had pledged themselves to break the tyranny of interest rates (Zinsknechtschaft) by reducing the cost of credit. There was also a strong movement in favour of the establishment of regional banks. Another interesting scheme put forward (which seems to have resembled in some ways the "Chicago plan" in America) was to make the "Grossbanken" purely banks of deposit without the power to lend money and the private bankers and medium-sized regional banks alone responsible for all lending operations. State guarantee of deposits and the complete nationalisation of banks were also advocated.[1]

[1] See *Bankenreform*, by Professor Kalveram (Kölnische Zeitung, 16th April, 1933), for a summary of these ideas.

The Banking Inquiry

A Commission of Inquiry was appointed which began its work on 6th September, 1933. Its duties were, "to inquire what functions should be given to the German banking system in order that German socialism may become a reality".

It was composed of Dr. Schacht and his deputy from the Reichsbank; six representatives of different Government Departments, including the State Commissioner for Banking (Dr. Ernst); Herr Keppler, and Dr. Feder, the economist of the N.S.D.A.P.; four members of the Supreme Economic Council; the President of the Statistical Office and two other experts. It will be noted that the joint stock and private banks were not represented by their own nominees, but by Dr. Schacht as leader of German banking.

Written reports were taken from both academic and practical experts; the questions being investigated were then discussed in public and private meetings. The proceedings terminated on 20th December, 1933, and the final report was issued in November, 1934.

The report first commented on the faults of German banking in the post-War period. Lending policy was unsound. Short-term credits from abroad were taken up in excessive amounts. Long-term advances were made on current account which could not be liquidated by the traditional method of issuing loans. Too many big credits were granted to a few large firms without a thorough examination of their position having been made. Small and medium-sized firms experienced great difficulty in obtaining loans at all and often had to pay higher rates for them. Cash reserves and liquidity reserves were totally inadequate. Finally, the report mentioned the over-expansion of the banking system that had taken place.

The positive recommendations of the Commission were surprisingly moderate, in that the nationalisation of the

banks would have been a comparatively easy step. Not only was an important part of the banking system—state banks, savings banks, etc.—under some sort of public control or ownership, but the state was also at that time the largest shareholder in the commercial banks and directly or indirectly interested in several other important banks of a specialised character. The Commission, however, considered that the banking system in its existing form could adequately discharge the functions required of it in the National Socialist State, provided that several working reforms and a uniform state control were introduced.

On 5th December, 1934, the Banking Act, embodying the main recommendations of the Commission, passed into law, to become effective on 1st January, 1935. It represents a compromise between a completely nationalised banking system and an entirely free one, by providing for a very far-reaching system of control through a Supervisory Board (Aufsichtsamt für das Kreditwesen) and a Banking Commissioner (Reichskommissar für das Kreditwesen), who is responsible for the actual administration of the new banking code and acts in accordance with the instructions of the Supervisory Board.

Scope of the act

The act regulates all banks with the exception of the Reichsbank, the Golddiskontbank, the Post Office and certain other institutions of an official or special character. The government is empowered to declare other types of business firms to be credit institutions, doubtful cases being decided by the Banking Commissioner. This power is meant to cover the finance departments of large industrial units which are regular lenders in the money market, and which might render difficult the control of credit movements and interest rates.

The words " bank ", " banker ", " savings bank " or phrases in which these words occur can only be used by credit institutions which were in existence at the time at

which the act came into force or which, if founded subsequently, possess a licence from the Banking Commissioner. The object of this provision is to protect the public against the employment of these words with intent to defraud. The use of the word "Kreditanstalt" was already restricted under general commercial law.

Cash reserves

The act reflects the desire of the legislators to restore confidence in the banking system and to prevent crises, not only by giving the state a large measure of control, but also by prescribing regulations governing the liquidity of the banks.

Banks must hold cash reserves consisting of cash in hand, balances with the Reichsbank and the Postal Cheque Office. Such cash reserves must not fall below a percentage to liabilities to be fixed by the Supervisory Board. This percentage, although capable of variations as between different groups or types of banks, may in no case exceed 10 per cent.

The liabilities to which cash reserves are related are defined as deposits, current accounts, credits which a bank has opened with another bank for the use of its customers, debts incurred with another bank (nostro liabilities), and liability under acceptances and bills. The Supervisory Board may allow debts incurred with another bank to be excluded. It should be noticed that the legislators have omitted savings deposits in the enumeration of total liabilities and also balances with other banks in the enumeration of cash reserves.

As the immediate enforcement of a high cash ratio would have resulted in severe hardship, a certain elasticity was introduced by giving the Supervisory Board the right to fix the percentage to be observed and also to exempt banks partly or wholly from the liquidity provisions; in this event, it may prescribe special regulations. The Banking Commissioner may also rule that credit institutions be temporarily freed from these provisions.

The cash liquidity percentage was not immediately fixed, as a sudden increase in cash reserves would have involved the banks in a heavy loss of revenue. This is clearly seen from the following figures. The average cash ratio of the five big Berlin banks in the years immediately preceding 1914 was about 5·7 per cent.; for the years 1929, 1930 and 1931, it was 2·3 per cent.; for December, 1934, it was about 2·1 per cent. It was estimated that the attainment of what is approximately the English cash ratio would have required the exchange of some quarter of a milliard of earning assets into non-earning assets and a loss of revenue of some RM. 20,000,000. Such a wholesale redemption of assets would have dislocated the money and capital markets, and it was therefore decided to allow the banks to increase their cash reserves gradually.

The raising of the cash liquidity of the German banks was advocated as long ago as 1908 by the Bank Inquiry of that year as a means, not only of making the commercial banks stronger, but also of giving the Reichsbank more control over the banks and the money market. The power now given to the Supervisory Board to vary the cash ratio will, in addition, give the authorities further control over the credit-creating powers of the banks.

So far, however, very little progress has been made towards raising cash reserves. The percentage for the five big Berlin banks of cash and balances with the Reichsbank and Post Office to current liabilities has actually fallen from 2·2 per cent. at the end of 1935 to 1·8 per cent. in June, 1937. For the banking system as a whole cash liquidity is even lower. So long as the state makes such insistent demands on the banks' resources, there seems to be little prospect of any improvement in the cash position.

Secondary reserves

Every credit institution must maintain a minimum ratio between its current liabilities and secondary

reserves. These reserves are to consist of commercial bills with not more than ninety days to run and securities which will be accepted as guarantees for loans (lombards) by the Reichsbank. This ratio is to be fixed by the Supervisory Board and may differ according to the type of institution concerned, but must in no case exceed 30 per cent. The Supervisory Board is further given the power to exclude nostro liabilities from the total of liabilities and to admit securities other than those defined above. Finally, the Supervisory Board may declare that this section need not apply to any single group of credit institutions and may in this event prescribe special regulations. The Banking Commissioner also has the right to exempt banks temporarily from observance of the ratio.

The commercial bills which must form part of the secondary reserves include first-class commercial bills of all kinds (provided that they bear three good signatures), bank acceptances, treasury bills and any other bills which are rediscountable with the Reichsbank.

The securities will consist mainly of treasury bonds, shares and bonds of German railways, bonds issued by certain mortgage institutions, bearer bonds of the Reich, states and municipalities, and certain other types of security.

The prominence given to gilt-edged securities as forming part of the banks' secondary reserves is interesting when it is remembered that the Reichsbank was empowered, by the Law of 27th October, 1933, to issue notes against securities which could be bought and sold in the open market. This law, together with the new Banking Act, will tend to provide a larger market for bonds and will enable the government to borrow more cheaply.

The exact proportion between secondary reserves and total liabilities has yet to be fixed by the Supervisory Board, but it should be noted that in all probability the banks already hold secondary reserves (mainly in the

form of " work-creation " bills, treasury bills and government securities) which exceed the proportion required by the act. There has, in fact, been a great expansion in these holdings, attributable to the necessity of financing the various large governmental work schemes. The proportion of bills (including treasury bills) and public securities to balance-sheet totals has, according to various estimates, increased for the commercial banks from 23 per cent. at the end of 1929 and 25·3 per cent. at the end of 1932, to 38·9 per cent. at the end of 1935 and to 44·3 per cent. at the end of 1936.[1]

Other investments

In order to prevent the immobilisation of funds, the act sets a limit to bank holdings of real estate and speculative investments. Holdings of shares, owners' certificates in mines, mining shares (other than permanent participations), and bonds not quoted on the German stock exchanges, must not exceed a percentage to current liabilities to be fixed by the Supervisory Board according to the class of credit institution concerned, but limited in any case to a minimum of 5 per cent. The Supervisory Board can also order that the restrictions shall not apply to certain types of bonds not quoted on a stock exchange.

The third Order of the Supervisory Board, dated 30th June, 1936, exempts from the restrictions securities not quoted on the stock exchanges, bonds of, and book debts against, the Reich and certain other bonds which are or can be taken by the Reichsbank as security against loans.

The act further prescribes that permanent participations and investments in property and buildings shall not exceed capital and reserves. For the purposes of this paragraph, the balance-sheet value of these permanent investments is to be taken.

[1] Reichs-Kredit-Gesellschaft. *Germany's Economic Position, 1936–37*, p. 48.

Ratio between capital and liabilities

The question of attaining a suitable relationship between capital and total liabilities received much attention in the Banking Inquiry. In the final report it was stated that the Supervisory Board should have the power to fix a proportion that would provide a greater margin of security for the banks' depositors. The ratio had, in fact, fallen from 32·3 per cent. in 1913 to 16·1 per cent. in 1925 and 8·9 per cent. in 1931. In order to avoid hardship, however, it was suggested that allowance should be made for variations in individual cases.

Accordingly, the act lays down rules governing the relationship between total liabilities and capital. Total liabilities (defined as deposits, current accounts, credits which a bank has opened with another bank for the use of its customers, nostro liabilities, liability under acceptance and bills, together with savings deposits) after deduction of short-term assets (i.e. primary and secondary reserves defined above) must not exceed a certain multiple of capital to be fixed by the Board. Capital is elaborately defined (as amended by the third Order of the Supervisory Board) and in the case of joint stock banks consists of capital, together with visible reserves, but not including hidden or extraordinary reserves.

The ratio of capital to net liabilities, which has yet to be fixed, may not in any case exceed 20 per cent. ; the Supervisory Board is allowed to vary the ratio for single banks and types of credit institutions (provided that the ratio is not exceeded) ; to exclude nostro liabilities from total liabilities ; and to include liabilities arising from a guarantee or endorsement.

Although the object of the legislators—the prevention of a repetition of any failure such as that of the Darmstädter und Nationalbank, through an expansion of operations excessive in relation to capital resources—is a sound one, yet there are certain difficulties in the way of its realisation. At the end of 1934, the ratio of capital

to net liabilities was estimated to be about 14 per cent. for private banks and 10 per cent. for the big joint stock banks. Since then the position has in no way improved. The attainment of a 20 per cent. ratio would, therefore, require either a very large reduction in the scale of operations of the banks—which would mean deflation—or an increase in their capital structure. The Supervisory Board has decided that it must be satisfied with a gradual improvement. Dr. Ernst, the Banking Commissioner, has, however, intimated that the Board would endeavour to fix a ratio in the course of the year 1937.[1]

Limitation of credits

The close relationship between the banks and industry in post-War Germany has already been alluded to. The system of interlocking directorships and of direct participations in industry caused the banks to lend too great a proportion of their resources to a few large borrowers, with the result that one of the cardinal principles of sound banking—namely, that investments should be spread as widely as possible—was neglected. Many of the heavy capital losses experienced in 1931 are attributable to this factor, an outstanding example being that of the Darmstädter und Nationalbank, the failure of which was largely due to the collapse of its biggest borrower, the "Nordwolle". In order to prevent unwise loan policies from endangering individual banks and the whole credit structure, the legislators have introduced certain safeguards.

The act prescribes that credits of any kind whatsoever granted by a bank to a single debtor must not exceed a percentage of its capital and reserves, to be fixed by the Supervisory Board. It is provided, however, that credits in excess of the legal maximum may be granted on condition that all the managers of the bank concur and that the Banking Commissioner is advised. Enterprises which are dependent on the borrower (either an individual

[1] *Der Deutsche Volkswirt*, 21st May, 1937, p. 1650.

or a firm) are to be considered as one and the same debtor. Credits granted to the Reich or to the states are excluded from the operation of this section. The Supervisory Board has fixed this percentage at 10 per cent. for credit institutions with balance-sheet totals of RM. 500,000 and upwards, and at 15 per cent. for smaller institutions.[1]

Additional elasticity in the application of this section has been introduced [1] by providing that the Banking Commissioner need only be advised when the credits granted exceed RM. 2000 in the case of banks with balance-sheet totals of up to RM. 50,000, and RM. 5000 in the case of banks with balance-sheet totals of over RM. 750,000. The object of these last provisions is to place as few obstacles as possible in the way of the smaller banks.

It should be added that a further Order [2] states that the granting of a credit comprises not only the opening of a new credit, but also the extension or increasing of an already existing credit. In the latter case it is provided, however, that if the credit already exceeds the legal maximum, it need only be reported if the increase amounts to 20 per cent. of the old credit.

Pooling of information on credits

A novel feature of the Banking Act, and one which gives the controlling authorities a thorough insight into the working of the credit system, is the obligation laid upon banks to report credits exceeding a given limit. Credit institutions are required to inform the Banking Commissioner every month of the names of all individuals or firms whose indebtedness of all kinds during the preceding month has exceeded RM. 1,000,000. This provision has now been put into force.[2]

The Banking Commissioner may inform the banks concerned (without giving details), if a borrower has obtained large credits from several different institutions. This information should prove extremely useful in preventing

[1] Third Order of the Supervisory Board, 24th June, 1936.
[2] Third Executive Order, 30th June, 1936.

big industrialists playing one bank off against another. Moreover, should the Banking Commissioner be in some doubt as to whether the total indebtedness of a borrower has been correctly stated (for example, whether participations have been included), he is empowered to demand additional information.

The precise nature of the indebtedness is not specified in the act, but will be determined by the Supervisory Board as, for example, has been done in its third Order, by which certain types of credit are excluded from total indebtedness.

Granting of uncovered credits

The act specifies a limit up to which uncovered credits may be granted without the presentation by the borrower of a statement of affairs or a balance sheet. This limit is fixed at RM. 5000, but the Banking Commissioner may stipulate a different amount for general or special application. It is desirable that a uniform procedure should be followed in respect of the information to be demanded under this section ; otherwise a form of competition might arise between the banks, in that some banks might try to attract customers by requiring less searching information than is demanded by others.

In order to protect the banks from dishonest borrowers, the act imposes heavy penalties for false information, even if no credit is granted.

Granting of credit to officials

In order to prevent credit institutions from granting too large a volume of credit to officials and to associated companies and individuals, the law lays down, in eight long paragraphs, the conditions under which advances can be made by a credit institution to its managers, members of its managing board and supervisory council,[1] to all officials and agents, and to similar persons in subsidiary

[1] Aufsichtsrat.

or parent companies. All credits require the express authorisation of the supervisory council and of the board of directors, and the unanimous approval of all managers. Similar requirements are envisaged for the granting of credits to firms closely connected with a credit institution through joint management or membership of boards of directors or supervisory councils. If these conditions are not complied with, the managers and members of the board of directors and of the supervisory council are liable for the repayment of the debt to the bank. The only credits excluded are relatively small advances to officials or employees of the banks, although when these exceed a certain proportion of their salary or remuneration, the Banking Commissioner must be informed.

As a further guarantee against mal-administration, it is provided that the emoluments of the managers and directors must not be paid out in totality, but a percentage (to be fixed by the Supervisory Board, but with a maximum of 50 per cent.) must be retained by the credit institution and invested. The sums thus retained can only be paid out when the beneficiary has left the bank, but in no case within one year of the date of his departure.

Banking Commissioner's general powers

It should be noted that the Banking Commissioner may exempt credit institutions temporarily from the observance of the various liquidity and credit ratios. This power has been given in order that banks shall not find themselves in difficulties on account of the new regulations; it has been used, for example, in the third Executive Decree of the Banking Commissioner[1] in which, *inter alia*, it is declared that these sections of the law do not apply to credit institutions in course of being liquidated. Should, however, any credit institution contravene the regulations laid down in the above sections, the Banking Commissioner is empowered to prohibit

[1] 30th June, 1936.

dividends from being paid in excess of a certain rate to be fixed by him.

Profitableness, control of competition and regulation of the cheque and clearing system

The final report of the Banking Inquiry states that "the restoration of a thoroughly healthy and efficient credit system presupposes that profitable working is re-established". The law attempts to achieve this object in three ways: by fixing interest rates and a scale of commissions; by the regulation of the cheque and Giro system (although considerations of credit policy are also important here); and by the control of competition through a licensing system.

The fixing of interest rates and commissions

The Banking Commissioner is empowered to declare as binding on all credit institutions the majority decisions of central organisations of credit as regards business practices (especially those relating to interest rates) and competition. If the Banking Commissioner does not approve of the decisions or if the organisations fail to produce regulations within a stipulated time, he can, in agreement with the Reichsbank, issue regulations himself.

Before 1932 these agreements were made exclusively by the banks. Of the regulations drawn up by the various central organisations, those of the Association (Stempelvereinigung) of the big Berlin banks were the most important and were taken as a standard by the majority of German banks, especially regarding rates for advances and deposits.

As a result of emergency legislation passed after the 1931 crisis, the provisions of these voluntary agreements formed the basis for the "Zinsabkommen" or rates agreement, which prescribed as from 1st January, 1932, maximum rates for deposits and normal rates for debit interest. In addition to this, an agreement governing competition between banks had been concluded in May,

1928, and was later declared binding by the State Commissioner for Banking. These two agreements were embodied in a general agreement of 9th January, 1932, and continued in force up to 1st January, 1937, when they were superseded by a new general and rates agreement which is to apply until 31st December, 1937, when it may be prolonged.

The new agreement was concluded on 22nd December, 1936. It does not differ radically from the earlier one, except in that credit rates show a reduction. The Banking Commissioner is in virtual control of the agreement, since he acts as chairman of the committee administering the rates agreement and can decide the committee's policy within certain limits.

It will be seen, therefore, that the Banking Commissioner has more or less direct control over money rates and to some extent over the profits of the banks.

The cheque and transfer system

Two forces seem to have been working for a reform of the system of non-cash payments. On the one hand, the economists' explanation of the power of banks to create credit and their arguments for control received recognition in the Banking Inquiry.[1] On the other hand, it was considered, by practical bankers in particular, that considerable overlapping and wastage occurred as a result of the simultaneous working of the two systems of payment, the cheque system roughly approximating to English practice and the continental Giro transfer system. It was argued that the operating costs of the cheque system were lower than those of the Giro organisation. Hence, an attempt should be made to establish a cheque and clearing system on English lines.

The Supervisory Board is now empowered to issue regulations regarding non-cash payments, especially between—

[1] See especially, *Die Inflationszeit*, by A. Speer, and *Liquiditätsfrage*, by Dr. Nordhoff, in the Evidence before the Banking Inquiry.

(a) members of clearing-house associations and other institutions (e.g. the Girozentralen and Genossenschaftliche Zentralkassen).

(b) different credit institutions and the head office and branches of the same credit institution.

The Board may also order the extent to which payments are to be settled through the Reichsbank, clearing-houses established by the Reichsbank or through the Post Office. Furthermore, clearing zones can be set up, and existing clearing and transfer organisations may be dissolved.

From the point of view of banking control, the establishment of clearing zones would probably mean that the Reichsbank would become an inter-regional clearing-house with which all banks would find it expedient, if not necessarily obligatory, to maintain larger balances than was the practice in the past. The Reichsbank would then be in a better position to control the banks by operating on their cash balances.

The act not only provides for an improved cheque-clearing system, but also empowers the Supervisory Board to fix special fees for non-cash payments, which have hitherto been provided, in most cases, free of charge. The imposition of these charges is defended on the ground that the banks' profits are at present prejudiced for two reasons: in the first place, credit and debit rates of interest are fixed by agreement; secondly, their expenditure is relatively fixed, since salaries, which constitute between 70 and 80 per cent. of their expenses, are determined by government salary tariffs. Further, the introduction of the new liquidity ratios would compel the banks to transfer their funds from profitable employment to less profitable use. Therefore, the banks should be compensated for this loss of revenue and for their inability to vary interest rates very much, by charging fees for services which, although expensive to the banks, have been rendered free. The introduction of a tariff of fees for non-cash payments would, therefore, not only

increase the revenue of the banks, but also help to reduce the cost of borrowing.

The transfer systems of the Reichsbank and the Post Office, however, are not affected by the Banking Act, and care will have to be exercised to prevent customers from dispensing altogether with the banks' services in the making of payments. But it is unlikely that the Supervisory Board will be anxious to apply this section of the act, on account of the technical difficulties involved.

Control of competition and the licensing system

To control the number of banks and thereby competition, and to make the banking system as safe as possible, extensive powers have been given to the Banking Commissioner and to the Supervisory Board.

The Banking Commissioner is placed in charge of a licensing system for all credit institutions, and all banks wishing to begin business require his permission. Such permission is also necessary where domestic banks wish to open branches and agencies in Germany or abroad and where foreign banks desire to open branches in Germany. Institutions in existence on 1st January, 1935, need not obtain a licence.

By the first Order of 9th February, 1935, the cases in which a licence is required were extended: the most important were the closing-down of a local branch; the extension of business in certain cases; an alteration in the status of a branch; an increase in the facilities offered by a branch (e.g. extension of working hours); the absorption of one credit institution by another if existing bank offices are to continue working; changes in legal form. These cases have been further extended by the third Order; for example, any change in the precise nature of the business carried on by a bank or its branches must now be duly authorised.

It will be appreciated that, by requiring banks to obtain permission before opening branches, the act

ensures that competition shall be restricted and the danger of over-banking eliminated.

The Banking Commissioner may refuse a licence on any of the following grounds : if the owners or managers of a credit institution or a branch are not trustworthy or do not possess adequate professional qualifications ; if the licence appears unjustified on local or general considerations ; if the business does not possess sufficient capital in Germany to enable it to carry on.

Besides being able to withdraw any licence if it is not utilised within a year or if the enterprise to which it was granted has not operated for a year, the Banking Commissioner is endowed with wide discretionary powers to prohibit the continuance of business on three grounds : if the licence has been obtained through false information, in which case penalties may be imposed ; if the managers, including managers of branches, are unsuited for their responsible positions ; if the credit institution has insufficient capital or is a danger to general economic interests. The prohibition of business may apply to a part only of the undertaking or to a branch.

These powers appear even more drastic when further details are considered. First, the prohibition of business or withdrawal of a licence may act as an order to liquidate and the Banking Commissioner may issue regulations as to the procedure to be followed in the winding-up. Secondly, every bank must keep the Banking Commissioner informed of any changes in the management of both head office and branches, of changes in capital, of any intention to merge with or to participate permanently in another institution, of the discontinuance of operations or the closing of branch offices and of changes in ownership in certain cases.[1] The Supervisory Board was also given the power to prohibit the continuance of credit institutions, if the credit system would thereby be improved, but this provision lapsed on 31st December 1935.

[1] Third Order of the Banking Commissioner.

These very wide powers give to the Banking Commissioner almost dictatorial control over the banking system, and much will depend on the degree of skill and impartiality with which they are used. The extent to which his powers have been exercised is not exactly known, although during 1935 the Banking Commissioner made use of the right of prohibition in four cases and is also believed to have cleansed certain banks of " undesirable " elements.

The existence of regulations does not necessarily mean that new entrants to the banking system will be discouraged ; this is unlikely in view of the official announcements made from time to time on the desirability of restoring the importance of the private banker and of the regional bank.

Savings deposits and the strengthening of the capital market

Special attention was given in the Banking Inquiry to the possibilities of widening the capital market. It was considered that many of the faults of the post-War period were due to the mal-investment of capital and, in particular, to the use of short-term deposits for long-term loans. Hence, the new law endeavoured to secure the separation of savings deposits from current accounts and ordinary deposit accounts, and the investment of savings deposits in special kinds of assets.

Savings deposits are defined as deposits of money that serve the purpose of investment and not of current payments, and which are characterised by the issue of savings books. Transfers of and cheques drawn against savings deposits may not be honoured, and payment can be made only against delivery of the book and only for a fixed maximum amount, unless notice of withdrawal has been given. Details have been arranged by the Supervisory Board. All savings deposits bear interest at the rates fixed by the Board. Similar legislation is found in the Argentine and in the United States.

The Banking Act provides that savings deposits shall be specially invested according to regulations to be published by the Supervisory Board. These regulations have not yet been issued on account of certain practical difficulties, but it may be assumed [1] that the legislators intended the banks to invest such deposits in gilt-edged securities. In fact such deposits are held in the form of mortgages, government securities and cash and liquid assets.

Lastly, the necessity for having detailed information about the relative proportions of current accounts, deposits and savings deposits is recognised in the act, which requires banks to separate these items in their monthly and yearly balance sheets, and to give figures showing the separate investment of savings deposits.

It is not yet certain what the effect of these regulations will be. If they lead to a clearer demarcation of functions and a lessening of competition between commercial and public banks, then they will have served a useful purpose from the point of view of the banking structure.

Publicity

The Banking Act has introduced important changes in regard to the submission of information and to the publication of statistics.

The new law makes it obligatory on credit institutions operating as private firms and partnerships, and on joint stock banks and public banks whose balance-sheet totals do not exceed one million reichsmarks, to submit to the Reichsbank yearly balance sheets and profit-and-loss accounts as well as *pro forma* balance sheets as at 30th June. All other credit institutions (i.e. the larger ones) must submit yearly balance sheets and profit-and-loss accounts and, in addition, monthly statements of their position.

The Supervisory Board is charged with drawing up regulations specifying the details to be given in the balance sheets (with the exception of the yearly balance

[1] Speech of Dr. Schacht, 17th November, 1934.

sheets) and monthly statements. The Reichsbank can issue instructions indicating the information and explanations that must accompany them and can also demand additional information. The Reichsbank is required to publish the monthly statements in the Official Gazette.

In order to avoid placing small banks in difficulties and to lessen the pressure of work on the Reichsbank, the Banking Commissioner is given authority, in agreement with the Reichsbank, to exempt credit institutions completely or partially from the requirements mentioned, and this power has been extensively used. Building societies, land credit organisations and all credit institutions in liquidation or bankruptcy have been exempted.

Furthermore, all credit institutions with balance-sheet totals of less than RM. 500,000 (roughly one-fifth of all credit institutions) are excused from drawing up the *pro forma* balance sheets required under the act, while the submission of monthly balance sheets is restricted to the largest institutions—banks with short-term liabilities of RM. 1,000,000 or more and savings banks with liabilities of RM. 10,000,000 and upwards.

The Supervisory Board has published details of the monthly balance sheets for the big banks and drawn up the form of the monthly statements and *pro forma* balance sheets required from other credit institutions and from private bankers. Details regarding the information required from savings banks and co-operative banks have also been made known. Every effort has been taken to make the balance sheets as informative as possible.

In addition to the information given in these monthly balance sheets, credit institutions must also submit to the Reichsbank reports on their investment position. Various schedules are prescribed for this purpose. Schedule A shows the investment of the savings deposits ; Schedule B gives the foreign business position ; Schedule C gives special information, e.g. the amount of " work-creation " bills, bank acceptances, treasury bills, tax credit notes, securities available for lombard with the Reichsbank and

so on. This schedule also calls for information on the maturities of long-term deposits and savings deposits with special terms of notice, together with information on credits running. Lastly, Schedule D calls for statistics of loans and deposits, in order that the series begun in the Banking Inquiry may be continued.

The degree of detail that will be published is left to the discretion of the Reichsbank. At the time of writing[1] the monthly balance sheets give the total figures, according to groups, of the 5 big Berlin banks, 72 special banks, 86 other institutions, 22 state and local banks and 20 Girozentralen.

The possession of this information concerning the working of the banking system, together with the special powers of the Banking Commissioner to obtain additional information, places the central bank in a very strong position for an enlightened control.

Compulsory audit

Prior to the Banking Act the audit of accounts was compulsory only for mortgage banks (1899) and for joint stock banks under the Decree of 19th September, 1931, which applied to all joint stock companies. In 1932, however, an Auditing Association (Verein für Depotprüfung) was formed to re-establish public confidence in the private banks by an examination of their books by impartial experts. This procedure proved so successful that the State Commissioner for Banking empowered the Association in 1933 to undertake the examination of all banks and banking businesses.

The rules regulating the examination of accounts of all credit institutions are determined by the Supervisory Board, which has taken the opportunity of standardising the procedure to be adopted. The Banking Commissioner issues regulations governing the examination of trust companies and institutions buying and selling securities for account of others.

[1] October, 1937.

All credit institutions are, therefore, now subject to a periodical audit by an impartial body.

Supervision

The final report of the Banking Inquiry stated that the most appropriate organisation for the banking system was that of private enterprise and individual responsibility, provided that public interests were adequately safeguarded by a system of state control. In order, however, to avoid the drawbacks of too rigid a system, the legislators endeavoured to make the control an elastic one. This they did by creating a framework of regulations, which have been described above, giving the controlling authorities power to amend them, to choose the date on which they should come into force and to exempt banks from their observance. The extreme importance of the functions of the controlling authorities will thus be appreciated, for the degree to which the law will be a success or a failure depends to a very great extent on the policy they adopt. The control is a threefold one. First, there is the Supervisory Board; secondly, the Banking Commissioner; and, lastly, the Reichsbank.

The Supervisory Board

This Board, which has jurisdiction over all credit institutions and branches of foreign credit institutions established in Germany and is the successor to the former Banking Committee, is established at the Reichsbank, and consists of the President of the Reichsbank Directorate as chairman, the Vice-President of the Reichsbank Directorate as deputy-chairman, a member nominated by the Leader and Chancellor of the Reich, the Secretary of State of the Finance Ministry, the Secretary of State of the Ministry of Commerce, the Secretary of State of the Ministry of Agriculture and the Secretary of State of the Home Office. The Banking Commissioner is not a member of the Board, but is entitled to take part in all sessions in an advisory capacity.

It will be noted that the Board is intimately connected with the various executive departments of state and with the Reichsbank, the object of this link being to facilitate the adoption of a uniform system of control for those banks subject to special legislation. Decisions and other orders of the Supervisory Board are made by the chairman (the President of the Reichsbank) in consultation with the other members; in the event of difficulty—which is defined as the opposition of any member to a decision—the government has the deciding voice. These provisions do not apply in the case of decisions on penalties, for which majority decisions are sufficient.

The most important function of the Supervisory Board is that of safeguarding the banking and credit system and eliminating any defects which may be found in it. This power, taken in conjunction with the provisions authorising it to establish rules for the conduct of business, gives the Board direct control over all banks and enables it to determine the degree of intervention to be undertaken by the government in the management of the individual banks. These powers might be used, for example, to further the financial policy of the government, by requiring the banks to take up certain types of bills or to prevent a general credit crisis by the adoption of appropriate measures either generally or against specific banks which were endangering or which threatened to endanger the general credit structure. The Board relies to a large extent on the information derived from the compulsory audit system, which reveals such practices as the use of short-term deposits for long-term investments, and on the advice offered by the Banking Commissioner.

The Supervisory Board is further entrusted with the task of fixing the various liquidity and credit ratios and of performing other discretionary and interpretative duties. The Board has the power to fix the ratio between capital and total liabilities; cash reserves and secondary reserves and liabilities; and to vary its definition of liabilities.

The Board fixes the maximum size of the credits to be granted to any single borrower by establishing the percentage of such credits to capital. It can issue regulations governing the granting of credits to officials of banks and affiliated companies and is to determine the percentage of emoluments accruing to managers which must be retained and invested. It can issue regulations concerning the investment of savings deposits and determine the notice required for their withdrawal.

The Board has also partial control over the revenue of the banks through its power to establish fees for non-cash payments, and is able to regulate the clearing system through its power of saying to what extent clearings are to be made through the Reichsbank and the Post Office, and through its control over the functioning of already existing clearing associations. Responsibility for the audit system also devolves upon the Board.

The Board has the right to make exceptions to the provisions of the act in several instances, notably to those relating to credits, liquidity ratios, and the investment of savings deposits. This power is an extremely important one, as it enables the Board to proceed gradually in its work of remoulding the banking system.

The Board is entrusted with certain judicial powers. It is to consider appeals against the decisions and rulings of the Banking Commissioner in certain cases and against the fines and direct compulsion employed by this official either in enforcing compliance with his orders or in punishing infractions of the Banking Law. The Board has authority to issue instructions governing the activities of the Banking Commissioner.

The Banking Commissioner

The Banking Commissioner alone comes into direct personal contact with the banks in the course of his duties. He is appointed by the Leader and Chancellor of the Reich on the advice of the President of the Reichsbank, and is made responsible for the administration of

the act in accordance with the instructions issued to him by the Supervisory Board.

The Commissioner is placed in charge of the licensing system and has therefore very wide powers over the establishment and continuance of banks. He can order banks to be liquidated, and can decide whether the officials of a bank are trustworthy and suitable for their positions ; his right to demand information on all staff changes helps him to keep in constant touch with any changes in management. He is also given the power to decide whether a firm is a credit institution within the meaning of the act. The Commissioner virtually controls short-term money rates through his ability to declare, as binding, majority decisions of central organisations regarding interest rates and the restriction of competition, and through his powers to issue such regulations himself, should the organisations fail to come to an agreement. He can stipulate in general, or in individual, cases the minimum amount above which any granting of unsecured credit must be accompanied by particulars of the borrower's financial position. The administration of the audit system for trust companies is placed in the Commissioner's care. He is also empowered to enforce the observation of his orders, to punish infringements of the law by fines and to limit the payment of dividends. The Commissioner is allowed to relax temporarily the provisions relating to liquidity and credit ratios, and to excuse banks from the requirements of submitting statistics.

The Banking Commissioner has almost unlimited rights to demand information about the business of the banks. He may require balance sheets, profit-and-loss accounts at any time, and for past dates, and may demand from officials information regarding all business transactions ; he may inspect the books and records of the credit institutions and, in general, carry out, or have carried out, all investigations which he considers necessary for the fulfilment of his duties ; he may communicate his findings to the credit institutions at his discretion. He is authorised

to attend and to participate in the annual meetings and all other meetings of shareholders, and the sessions of the governing bodies of credit institutions; he may delegate a representative to exercise this function on his behalf. He may demand the calling of special meetings and other assemblies of the members, the summoning of the administrative and supervisory bodies, and the publication of the agenda of such meetings. He is empowered to demand information regarding foreign indebtedness and may introduce temporary regulations, in time of emergency, for the purpose of control. Finally, should the Banking Commissioner wish to obtain further information about the banks, he can request the Reichsbank to furnish him with all the information it possesses.

The degree of control which the Banking Commissioner exercises over the banking system is emphasised when it is borne in mind that only certain of his rulings and orders can be challenged and referred for final judgment to the Supervisory Board. The remainder are binding and irrevocable.

Appeal is allowed in the following main cases: against rulings as to whether a firm is or is not a credit institution; against the withholding and withdrawal of licences and against an order to prohibit the continuance of business; against decisions as to whether the words "bank", "banker", "savings bank" can be used; against penalties and enforcements. The decisions of the Supervisory Board in these cases are by majority vote.

The remainder of the Banking Commissioner's powers are unchallengeable. Amongst these may be especially mentioned: his powers to order a credit institution to be wound up; his order to be informed of any changes in personnel; his decision to limit the payment of dividends in the case of banks not observing the liquidity ratios; his powers of demanding information; his control over the examination of trust companies; his rights in connection with the determination of short-term money rates and the conclusion of agreements restricting competition; his decisions regarding the limits beyond which the granting

of uncovered credits must be accompanied by a statement of affairs.

The exercise of these numerous functions not only calls for great technical ability, but also for what is perhaps even more important, when taking into consideration the intimate personal relationship that must subsist between the banks and the Commissioner—considerable tact.

The Reichsbank

Despite the extensive rights conferred on the Supervisory Board and the Banking Commissioner, the Reichsbank remains, in the last analysis, in real control of the banking and credit system.

Its direct powers under the Banking Act are comparatively limited ; the right to receive statistics from the banks ; the determination of the form in which the statistics shall be supplied ; and the demanding of explanations of balance sheets and profit-and-loss accounts. Indirectly, however, it has considerable influence in the administration of the act, as both the President and Vice-President of the Reichsbank are leading members of the Supervisory Board. The Banking Commissioner, moreover, can only exempt banks from the section of the act imposing on them the obligation to supply statistics with the consent of the Reichsbank.

Conclusion

Banking in Germany is thus now subjected to a dual control. The Reichsbank, armed with the technical devices referred to earlier, supplemented by certain provisions of the act, is in supreme control so far as the quantity of credit is concerned. Qualitative control is in the hands of the Supervisory Board and its executive officer, but the two aspects of control are harmonised by the close relationship which subsists between the respective authorities. The Banking Act is therefore an ingenious measure whereby the state is able both to safeguard the interests of the community and to use the banking system

in the furtherance of its economic policy, without assuming the direct responsibility towards the depositing and borrowing public which complete nationalisation would entail.

So far as the practical application of the act is concerned, however, while the authorities are in a position to obtain a very complete and useful insight into the activities of the banks, the continued non-enforcement of several of the important liquidity provisions must result in the actual position of the banks differing in many material respects from that originally contemplated by the legislators.

GREAT BRITAIN

GREAT BRITAIN

The History of Banking Control

Although in any standard work on British banking law one may find reference to well over fifty acts of parliament which still affect banks in Great Britain and Ireland, British banks are probably as free from legal control as any others in the world. Great Britain, however, provides probably the first example of a self-contained joint stock banking code, though most of its provisions have long since been repealed or embodied in the general law governing all limited companies.

The earliest English act was the Banking Copartnerships Act of 1826, which for the first time permitted note-issuing banking partnerships of more than six partners to open for business, though only at a distance of more than 65 miles from London. Although the partners of such a bank remained severally responsible, they were given the right of suing and being sued jointly in the name of one of the bank's officers. This act also made provision for registration and returns, each bank formed under it being required to make an annual return to the Commissioner of Stamps of its name, the names and addresses of partners and officers, and the names of towns in which or on which it issued notes and bills. The Bank Charter Act of 1833 specifically permitted banking partnerships of more than six partners to conduct business within 65 miles of London, provided that they did not issue notes or bills payable on demand. As a result of these two acts a number of banking copartnerships were founded, and it was not long before the question

of their regulation was raised, for the management of many of them was far from being beyond reproach. In words which have almost exact counterparts in statements made a century later in other countries, it was declared in the House of Commons in 1836 that "the vast and growing system of joint stock banking" was "subject to no legal regulation", despite the fact that "it constituted an uncontrolled element of tremendous power in the Nation's monetary system".[1]

In 1836 a Select Committee of the House of Commons was appointed to inquire into joint stock banks, as they had now become known, and it issued reports in 1836, 1837 and 1838. Some of the proposals of the Committee are worth noting in brief; that the obligation to make annual returns should be more strictly enforced; that the deed of settlement of a new bank should be required to be approved by some competent authority; that banks should not start business until they had an adequate subscribed and paid-up capital; that the periodical publication of balance sheets should be made compulsory; that dividends should not be paid until bad and doubtful debts had been written off; that banks should not be permitted to purchase, or advance against the security of, their own shares; and that guarantee funds (reserves) should be set apart and invested in government securities. These are just the problems which have been exercising the thoughts of banking legislators in a number of countries in recent years.

The further regulation of joint stock banks was not effected until 1844, and then it went by no means as far as the proposals of the Select Committee. Of the two acts of this year, the Bank Charter Act only slightly affected joint stock banks, restricting the right of note issue of country banks and requiring that "every banker in England and Wales who is now carrying on or shall hereafter carry on business as such shall on the first day

[1] See S. E. Thomas, *The Rise and Growth of Joint Stock Banking*, chap. v.

of January each year . . . make a return to the Commissioners of Stamps and Taxes [now the Inland Revenue] . . . of his name, residence and occupation, or in the case of a company or partnership, of the name, residence and occupation of every person composing . . . such company or partnership, and also the name of the firm under which such banker, company or partnership carry on the business of banking ".

The Joint Stock Bank Act, 1844, may be briefly summarised as follows. All applications for opening new banks were to be referred to the Committee of the Privy Council for Trade and Plantations, and only on the advice of this body could the necessary letters patent be granted. The deed of partnership of every new bank was to contain specific provisions for annual general meetings, for the election and qualification of directors, with retirement every four years in rotation (no director to be eligible for re-election within twelve months of retirement), for preventing the bank making advances on its own shares, for the publication of a monthly balance sheet, for the yearly audit of accounts by auditors chosen by the shareholders, and the yearly communication of the auditors' report, balance sheet and profit-and-loss account to every shareholder. No new bank might start business until all its shares had been subscribed and at least half its capital paid up, the minimum total subscribed capital being fixed at £100,000, and the minimum value of a share at £100. Though such banks became legal entities, shareholders continued severally liable. An annual return in the form of a statement of the bank's name, the names and addresses of all members, directors and managers, and the addresses of branches, was required to be made to the Commissioners of Stamps and Taxes. Similar information was to be posted in a conspicuous place in every bank's head office. The act also contained provisions for the transfer and registration of shares, and calls on shares, which need not be considered here.

The Joint Stock Bank Act, 1844, applied primarily to

new banks, for, though already existing banks could apply for letters patent under it, few took advantage of this in view of the severity of its provisions. The main effect of the act was, therefore, to limit the formation of new banks, and, in fact, very few banks even came within its ambit, for it was repealed in 1857. The chief bank formed under it, the Royal British Bank, failed in 1856.

Limited liability for companies of seven or more persons, other than banking companies, which were expressly excluded, came with the Limited Liability Act of 1855 and the Joint Stock Companies Acts of 1856 and 1857. The principle was not long in being extended to banking companies : the Joint Stock Banking Companies Acts of 1857 and 1858 made it possible for banks with seven or more members to register as limited banking companies. The act of 1857 repealed the Joint Stock Bank Act, 1844, and made it compulsory for banks formed under it to re-register under the new act ; banks formed under the acts of 1826 and 1833 were *permitted* to register, while of new banks, those with over ten members were compelled and those with seven to ten members were allowed to register under the 1857 act. The act itself introduced few new forms of control. It provided, however, for the appointment by the Board of Trade of inspectors to examine the affairs of a bank, on the application of at least one-third, in number and value, of the bank's shareholders. Perhaps the most interesting feature of the act from our point of view was its first clause, which stated that the Joint Stock Companies Acts of 1856 and 1857 were to be deemed to be part of it. It was the first time that English banks had been subsumed under the general law of joint stock companies. The banking code, instead of standing alone, had now to be read in conjunction with the general law for companies.

The period 1844–60 was one of great criticism of banking law and practice, and it is interesting, again bearing modern laws in mind, to mention a few of the

suggestions made.[1] One proposal was that a limit should be set to the volume of deposits a bank could accept, by reference to its capital, though nothing as generous as the provisions prevailing in most banking laws to-day was put forward. The question of government inspection of banks was also much discussed, and among the justifications put forward for such a scheme were (1) the practice of granting large advances to influential individuals and (2) that of tempting customers away from other banks by offering very favourable terms. It may be asked whether modern provisions for the limitation of loans to one customer and for the control of interest on deposits are not reflections of the same ideas. Government audit was rejected, as being impracticable (in banking and especially in branch banking) and expensive. Demands were also made for more uniform and more informative balance sheets, and another topic which received attention was the provision of reserves either from undistributed profits, or on formation through the issue of shares at a premium—practices already long favoured by some of the best banks. The unwise extension of branches was another matter which was severely criticised from time to time. In spite of the discussions on these points, no legislation was introduced.

It has already been noticed that while the act of 1844 gave banks their own code, the act of 1857 allowed for the extension to banks of the provisions of joint stock company law. The Companies Act of 1862 went a step further in stating that "No company, association or partnership consisting of more than ten persons shall be formed, after the commencement of this act, for the purpose of carrying on the business of banking, unless it is registered as a company under this act or is formed in pursuance of some other act of Parliament or Letters Patent" (s. 4). Henceforward new banks registered as joint stock companies. It was possible for old banks

[1] See S. E. Thomas, *op. cit.*, chap. xiv.

also to register under the 1862 Companies Act either as limited or as unlimited companies, and when many of the bigger banks did register in the seventies, it was as unlimited companies.[1] At this time joint stock banks might thus be governed by one of four codes—the acts of 1826, 1833, 1857 and 1862.[2]

While, in order to afford protection to depositors, many of the most important banks maintained an unlimited liability, the failure in 1878 of the City of Glasgow Bank (an unlimited company whose shareholders were called on to meet the bank's deficit on liquidation) made it evident that shareholders also should be afforded protection. The Companies Act, 1879, was passed with this object. By arranging for limited companies to increase their nominal capital, if they wished, by increasing the value of each share, yet enacting that such increase in capital should only be called up in case of liquidation, it endeavoured to preserve for depositors some protection of this sort, while setting a definite limit to the liability of shareholders. Encouragement was given to banks to adopt this principle of "reserve liability" (very similar to the American principle of double liability), by providing that banks registered as unlimited might re-register as limited under the act. By this act, therefore, yet another category of banks came into existence, though some banks re-registered as limited without adopting the new principle.

The 1879 act contained one new provision for control, in requiring bank auditors to state annually that the

[1] In 1874 there were in England and Wales 69 banks with unlimited liability and only 49 with limited liability. It was still widely felt that unlimited liability strengthened a bank and gave its depositors special protection.

[2] To provide an example from the components of one of the Big Five (Westminster Bank Ltd.), Stuckey's Banking Co. was founded in 1826 under the law of that year, London and Westminster Bank in 1834 under the 1833 act, Alliance Bank of London and Liverpool Ltd. in 1862 under the 1857 act and Parr's Banking Company Ltd. in 1865 under the 1862 act. They were all separate entities in 1865. (See T. E. Gregory, *The Westminster Bank through a Century*.)

published balance sheet of the bank they audited was a full and fair balance sheet, properly drawn up and exhibiting a true and correct view of the state of the bank's affairs.

The various companies acts were consolidated in 1908 and again in 1929 and all banking companies are to-day controlled by the latter act. Thus it has come about that the former joint stock banking code has entirely disappeared in England and the only provision relating to the control of banks (apart from the companies acts) is that of the Bank Charter Act, 1844, which requires certain returns from banks not registered under the companies acts. A third and final stage of the statutory control of banking has thus been reached. Although the first Companies Act of 1862 applied the general body of company law to new banks and to such old banks as chose to register under it, a number of banks still continued to be governed by the acts of 1826, 1833 and 1857. To-day these have all disappeared and no distinct banking code exists; apart from a few special sections in the 1929 act, banking companies are subject to exactly the same regulations as other companies.

Legal Control as it exists To-day

Although the joint stock banks, the history of whose legal control has just been traced, are to-day of preponderant importance in the English banking system, they are by no means the only commercial banks operating in this country. In addition to the companies, which may be subdivided into public limited, private limited and private unlimited companies, there are also partnerships; banks created by royal charter, by special act of Parliament or under some general act such as the Industrial and Provident Societies Act; and finally banks incorporated abroad. The following table[1] shows the

[1] Reproduced by kind permission of the editor of the *Bankers' Magazine* from an article by the author published in February, 1937.

number of banks working under each form of constitution in 1936, and the distribution among the different forms of the different types of commercial bank—deposit banks, merchant banks and acceptance houses, colonial and dominion banks, eastern exchange banks and banks engaged primarily in foreign business.

	Public Limited Companies	Private Limited Companies	Private Unlimited Companies	Chartered or by Act of Parliament	Partnerships	Incorporated Abroad	Total
English, Scottish and Irish deposit banks	26	..	3	4	..	..	33
Australian, Canadian and African banks	5	..	..	2	..	16	23
Eastern banks	4	1	..	1	..	4	10
Merchant banks and acceptance houses	3	16	1	..	24	..	44
Engaged in foreign business	16	8	..	1	5	35	65
Miscellaneous	3	..	..	3	..	..	6
	57	25	4	11	29	55	181

As mentioned above, of the 181 institutions thus accounted for, by far the most important are joint stock companies. The other banks, which cannot be considered here, are subject to only one form of control[1]—they are still required to make certain annual returns to the Commissioners of Inland Revenue. Many of them, in fact, do not even observe this regulation, and the requirement is of negligible importance as an instrument of control.

Of the companies the biggest and most important, and in particular the Big Five, which own about 8600 out of some 10,300 branches and banking offices in England,

[1] With the exception that chartered banks are governed by the terms of their charters, and banks formed under general acts by the terms of those acts.

are public limited companies. For our purposes the main difference between a private and a public limited banking company is that the former is not required by law to publish an annual balance sheet and profit-and-loss account. Some private companies do, however, in fact publish balance sheets and even profit-and-loss accounts. Nor are its directors required by law to hold qualification shares. On the other hand, no appeal may be made to the public for capital and the shareholders' rights to transfer their shares are limited. There are no public unlimited banking companies in this country, but there are still four private unlimited companies. These differ little from private limited companies, except that the liability of members is unlimited.

One or two sections of the Companies Act, 1929, as has been mentioned, apply specifically to banking companies. Under section 358 "no [English] company, association or partnership consisting of more than ten persons shall be formed for the purpose of carrying on the business of banking, unless it is registered as a company under this act, or is formed in pursuance of some other act of parliament or letters patent". This section having virtually imposed the requirements of the act on all the biggest institutions, section 131 goes on to lay down that every "limited banking company . . . shall, before it commences business, and also on the first Monday in February and the first Tuesday in August in every year in which it carries on business, make a statement in the form set out in the Seventh Schedule to this Act". This form covers particulars of the bank's share capital, the number and denomination of shares, the number issued, calls made and sums received through them, and the assets and liabilities of the bank on the previous 1st January or July. Copies of this statement have to be posted in every branch, and must be made available to shareholders and creditors (the latter including, of course, depositors). The only other part of the act relating specifically to banking control is section 135, which

empowers the Board of Trade to appoint inspectors to investigate and report on the affairs of a bank, on the application of shareholders holding not less than a third of the shares issued. Any officer or director found guilty of an offence for which he is criminally liable is to be prosecuted by the Director of Public Prosecutions. As far as the writer is aware, no such inspection has been made in recent years.

The Companies Act requires any bank incorporated abroad to deliver to the Registrar of Companies, within one month of the establishment of a place of business in this country, a copy of its charter or statutes in English, and a list of directors and their places of residence. A balance sheet has also to be delivered annually to the Registrar, and full publicity of the company's country of origin must be given in prospectuses, at its place of business and on letter paper and official publications. The company must also make it publicly known whether or not its shareholders' liability is limited.

The foregoing are the only special provisions in the Companies Act, 1929, relating to banking companies. It will not, however, be out of place to mention a few other leading provisions, the contents of which have their counterparts in banking codes in other countries. Every English limited company has a memorandum and may have articles of association. The memorandum of association is the instrument in which the company sets out its proposed relations with other persons and bodies. Its terms may be changed, but only to achieve certain limited purposes, and the alteration must receive the consent of three-quarters of the shareholders assembled at a general meeting, and of the Court, which has to assure itself that all persons affected by the alteration are satisfied with it. The articles of association, which most companies limited by shares possess, though the law does not make it necessary, prescribe a company's internal regulations. The contents depend very largely on the business which the company is to transact, and are more

easily varied, for the permission of the Court is not required, though three-quarters of the shareholders at a duly convened meeting must concur.

It is not without interest to look briefly at the memorandum of association of one of the clearing banks.[1] Failing a legal definition in this country of what commercial or deposit banking consists of, the memorandum now quoted gives a good idea of the powers which a modern English deposit bank reserves for itself.

It is quite a short document, which starts by giving the bank's name and address and the amount of its capital, and states that the liability of its shareholders is limited. In addition it defines the "objects" of the bank, i.e. the business the bank claims the right to carry on, as follows :—

(1) To carry on the business of banking in all its branches and departments, including the borrowing, raising or taking up of money and the lending or advancing of money, securities and property; and the discounting, buying, selling and dealing in bills of exchange, promissory notes, drafts, and other instruments and securities, whether negotiable or not; and the buying, selling, and dealing in bullion and specie; and the acquisition, holding and dealing with stocks, funds, shares, debentures, debenture stocks, bonds, obligations, and securities and investments of all kinds; and the receipt of money and valuables on deposit or for safe custody, and the negotiation of loans and advances and the collection and transmission of money and securities and the management of property; and the transaction of all kinds of agency business commonly transacted by bankers.

(2) To purchase, acquire, and undertake the whole or any part of the business, property, goodwill, and liabilities of any person, partnership, or company carrying on any business which this Company is authorised to carry on, or possessed of property or rights suitable for any purposes of this Company.

(3) Generally to purchase, to take on lease, or in exchange, or otherwise acquire any real or personal property, and any rights and privileges which the Company may think necessary or convenient with reference to any of these objects or the

[1] Midland Bank Ltd., by courtesy of the bank.

acquisition of which may seem calculated to facilitate the realisation of any securities held by the Company, or to prevent or diminish any apprehended loss or liability.

(4) To enter into any arrangement for sharing profits, union of interest, co-operation, joint adventure, reciprocal concession, or otherwise with any person, partnership, or company.

(5) To establish and promote any company for the purpose of acquiring any property belonging to or in which this Company is interested, or for any other purpose which may seem conducive to the Company's interests.

(6) To issue debentures, debenture stock (whether perpetual or otherwise), circular notes, bills, drafts, and other instruments and securities, whether payable to bearer or otherwise, and to make the same or any of them assignable free from equities.

(7) To effect and obtain all such insurances and guarantees, or counter-guarantees, as may seem expedient.

(8) To take or concur in taking all such steps and proceedings as may seem best calculated to uphold and support the credit of the Company, and to obtain and justify public confidence, and to avert or minimise financial disturbances which might affect the Company.

(9) To establish and support, or aid in the establishment and support of associations, institutions, funds, trusts, and conveniences, calculated to benefit employés or ex-employés of the Company, or the dependants or connections of such persons, and to grant pensions and allowances and donations to any persons who have been in the employ of this Company, or of any persons whose business may have been acquired by this Company.

(10) To sell, improve, manage, develop, exchange, lease, mortgage, dispose of, turn to account, or otherwise deal with all or any part of the property and rights of the Company for the time being.

(11) To do all such other things as shall seem to the Company incidental or conducive to the attainment of the above objects or any of them.

This memorandum is couched in the widest possible language, and it needs to be, for no company may do any act that is outside its objects, and changes are not easily introduced.

The other sections of the Companies Act to which it

appears useful to make allusion here are those dealing with prospectuses, general meetings, the reduction of capital, accounts, audit, and the appointment and responsibility of directors.

In the first place shareholders or prospective shareholders are protected against false prospectuses. The law holds every director, person named as director or authorising an issue of shares, and every promoter of a company personally liable for loss suffered by subscribers to an issue through untrue statements in a prospectus, unless it was issued without his consent, knowledge or authority, or he had reasonable ground to believe that the statements (if purporting to be those of experts) were true.

Another section of the act protecting shareholders is that which requires that all limited companies should hold a general meeting at least every calendar year and not more than fifteen months after the preceding meeting. Extraordinary general meetings can always be convened on the application of shareholders holding at least 10 per cent. of the paid-up capital.

Creditors, which in the case of banks would include depositors, are protected by the section relating to the reduction of capital. The law permits reduction of share capital only (a) where it is not repugnant to a company's articles, (b) after the passing of a special resolution which requires the assent of three-quarters of the shareholders assembled at a general meeting, and (c) after permission has been obtained from the Court. Any creditor may object, and the Court may order his debt to be either discharged or secured.

All companies must keep proper books of account and, excepting private companies, must send to shareholders at least seven days before every annual general meeting an up-to-date balance sheet and profit-and-loss account, together with a directors' report with recommendations as to the dividends to be paid and the amount to be carried to reserve. The balance sheet itself has to

meet certain important requirements. It must contain a summary of authorised and issued capital, as well as capital paid up; redeemable preference shares and their dates of redemption must be separately shown; liabilities and assets must be set out in sufficient detail to disclose their general nature and to distinguish between the amounts respectively of fixed and floating assets. The method of valuing fixed assets must be stated. If any liability is secured by any of the company's assets, the fact must be stated, though the particular assets need not be named. Assets consisting of loans to or shares in subsidiary companies (and the Big Five are interested in 16 other banks) must be set out separately in the balance sheet, and a statement must be included showing how the profits and losses of subsidiaries have, so far as they concern the company in question (i.e: the holding company), been dealt with in or for the purpose of the holding company's accounts. In particular, attention must be drawn to how far provision has been made for the losses of a subsidiary company, and how far such losses have been taken into account by the holding company in arriving at its disclosed profit or loss. Details must be given of any qualification in the auditors' report on the subsidiary company.

The accounts of limited companies have ordinarily to contain or be accompanied by particulars of loans to directors and officers and of the remuneration of directors, but banks are not required to disclose loans made in the ordinary course of business. It will be noticed that there are no requirements as to the scope or form of the profit-and-loss account.

The shareholders appoint auditors each year at the annual general meeting. The following are not eligible to be appointed :—directors and officers of the company, the partner or employee of an officer, a body corporate (the latter because a body corporate cannot be made personally responsible). Every balance sheet of a company must be accompanied by an auditors' report

stating whether the auditors have obtained all the information or explanations required, and whether the balance sheet is properly drawn up so as to exhibit a correct view of the company's affairs. Auditors have a right of access at all times to all books, vouchers and accounts, and may ask for any information required in the performance of their duties.

Directors must consent in writing to act as directors, and must take up any qualification shares the company's articles may require. Undischarged bankrupts are excluded from directorship and managership, except with permission of the Court. The acts of a director or manager, however, are valid, in spite of any defect afterwards discovered in his appointment or qualification. It is the duty of a director to disclose to other directors his interest in any of the company's contracts.

The directors of a company are generally personally responsible for infractions of the law by a company. In practice, however, it is only the company itself which can proceed against the directors, unless the company goes into liquidation. An individual shareholder can in law sue the directors of a company, but this is in practice a rare event. Creditors have no right to initiate proceedings for negligence or breach of trust, except where a company is in liquidation.

It can thus be seen that some of the special provisions of foreign banking codes have their counterparts in the general English company law, but that, at the same time, the control thus imposed in this country is elementary compared with the detailed regulations in force elsewhere, and is only of such character as to achieve a reasonable degree of publicity and supervision.

Credit Control

The control of credit by a central bank lies outside the main scope of this book, but it appears necessary to write a brief description of the control exercised by the Bank of

England, in order to dispel any belief that, in the absence of detailed legal regulation, the joint stock banks are free to pursue their own individual policies. The credit control of the Bank of England is based, not on law, but on convention, the accidents of the structure of the banking system, and the prestige of the central bank. It is, however, as effective in shaping commercial bank policy as if it were imposed by law.

There are two ways in which the central bank may effect a quantitative control of credit ; it may control the price of credit and the volume of credit. The two are not, of course, easily distinguishable, for an increase in money rates leads normally to a contraction in the demand for, and thus in the volume of, credit, while a decrease in the amount of credit which the banks are able to grant results necessarily in a rise in the price of credit. The distinction is, however, useful in facilitating a description of the most important weapons of credit control, bank rate and open-market operations.

Bank rate, the Bank of England's official discount rate, achieves its effect mainly through a convention that the various rates quoted in the London money market shall ordinarily be related to it. The clearing banks' London deposit rate, for instance, is normally fixed at about 2 per cent. below bank rate ; call rate at 1½ per cent. below it ; the rate for advances at 1 per cent. above it, with a minimum of 5 per cent. (subject to special negotiation). Market discount rate is not tied by convention directly to bank rate, but as one of the chief factors affecting it is call rate, a change in bank rate is usually reflected by a change in the market rate of discount for traders' acceptances, bankers' acceptances and treasury bills.

In easy times, however, money may be so cheap that the market rate of discount falls away far below bank rate, and bank rate is no longer " effective ". Similarly, when the supply of bills is short, market discount rate may rise to within a very close margin of bank rate. Again, from June, 1932, until the time of writing (September, 1937),

bank rate has been at 2 per cent., but the London deposit rate has not been reduced below ½ per cent. Nor, as far as rates on loans and advances are concerned, can the effect of bank rate changes always be immediate; such rates are fixed by agreement and cannot be suddenly altered, except where they are stated to be at a given number of points over bank rate. On the other hand, it may happen that the market rate of discount may influence bank rate, the Bank bringing the latter into line with market conditions, to make it effective. Bank rate may lead the way, but it cannot be long maintained against the current trend of the market. It must therefore be recognised that bank rate by itself is limited in its power to affect the various rates charged in the money market.

While bank rate was the instrument upon which emphasis was laid in pre-War accounts of credit control, it has been largely superseded since the War by open-market policy, i.e. the sale or purchase of assets in the open market by the central bank.

Open-market operations achieve their effect by altering the cash base upon which the banks create credit. There exists a convention by which the clearing banks keep their reserves, other than till money, in the form of a deposit at the Bank of England, and a further convention by which the total of reserves[1] is maintained at a given ratio to the deposit liabilities of the banks, on the average at just below 11 per cent. Thus a reduction in bankers' deposits at the Bank makes necessary a decrease in clearing-bank deposits (by means of a reduction in assets), while an increase makes a rise in deposits (and assets) desirable, if the banks are to earn to full capacity. A third convention, that the clearing banks shall not rediscount at the Bank of England, gives open-market operations added effectiveness.

Bankers' deposits at the Bank are subject to the play of a number of forces. All payments made by the banks or their customers to the Bank or its customers, of whom

[1] i.e. deposits at the Bank and till money.

the government is the chief (for example, tax payments) reduce bankers' deposits. Movements in the opposite direction, e.g. the repayment of government borrowings, increase bankers' deposits. Under a gold standard an inflow of foreign funds, if it involves a shipment of gold, also increases bankers' deposits, for the clearing banks do not hold gold themselves, but exchange it for a deposit at the Bank. An outflow of gold has a contrary effect.

It will be seen that, if it is desired to maintain an even volume of commercial bank credit, it falls to the central bank to offset one influence on bankers' deposits against another. Thus the payment of taxes is normally offset by a redemption of treasury bills; an inflow of gold by a sale of securities by the Bank to the market. Similarly, if it wishes to effect a change, the Bank will refrain from offsetting, or will take isolated action.

Open-market policy may be employed with three objectives. First it may be used to supplement bank-rate policy. Should the clearing banks show any unwillingness to adapt their rates to a change in the official rate, the Bank can compel them to do this by manipulating their cash base. Secondly, open-market operations can be used alone, to offset temporary changes in the cash base of the clearing banks, when it is not desired to alter bank rate. For example, an inflow of £5 millions of gold, at a time when it was not desired to expand credit, might be neutralised by a sale of securities by the Bank. Thirdly, open-market policy may be used for major operations, without changes in bank rate, i.e. it may displace bank-rate policy. This is particularly likely to happen when bank rate has been reduced to a low figure and it is still desirable to encourage expansion. When bank rate is, for example, at 2 per cent., a reduction below this figure is not likely to have any great effect. There are upper and lower limits beyond which it is not practicable to extend bank rate. Similarly there are occasions when speed of action is essential, and open-market policy is then the more effective instrument.

The technical devices employed in open-market operations were briefly referred to in the Macmillan Report, 1931, and may be summarised as follows :—

(1) The sale or purchase of securities to offset gold movements.

(2) The sale of short-dated securities (e.g. treasury bills) and the purchase of long-dated securities,—where it is desired to influence the margin between long-term and short-term rates. There is little evidence for the use of this method.

(3) Acquiescence in changes in the cash base of the clearing banks brought about through some other element in the market.

(4) An isolated sale or purchase of securities, not designed to neutralise, but to initiate a change.

To these may be added the purchase of securities to offset a seasonal demand for bank notes by the public, or a demand due to foreign hoarding of Bank of England notes ; an open-market purchase of gold by the Bank ; and probably other distinct variations. Finally, the institution of the Exchange Equalisation Account has introduced further refinements and further possibilities of control.

The Exchange Equalisation Account, consisting, as established in 1932 and augmented in 1933 and 1937, of £575 millions, is manipulated by the Bank under Treasury control, and is employed primarily to smooth out variations in the exchanges. The Account offers currency for sale when offerings of currency in the market fall short of those for sterling, and sterling when offerings of currency exceed those of sterling. The sterling funds of the Account are held for the most part in government securities, and of these the majority are, it is believed, treasury bills. Currency holdings have sometimes been converted into and held in the form of gold. The Account may be manipulated, not only to smooth out variations in the exchanges, but also to neutralise the effect of sales and purchases of currency on the internal credit structure. If, for example, there were a flight of capital from France

to the value of £100 millions, the following might be the sequence of events :—the value of the franc would fall; the Account would purchase francs, acquiring sterling to pay for them by selling £100 millions of treasury bills; the clearing banks or their customers who supplied the francs would receive £100 millions, and bankers' deposits at the Bank would be increased to the same extent; the Account, however, would have sold the treasury bills mentioned above to the clearing banks or their customers, and this would reduce bankers' cash by £100 millions. The only difference between the position before and the position after this series of transactions would be that the banks or their customers would hold treasury bills instead of francs and the Account francs instead of treasury bills.[1] In the case of an excess demand for francs the opposite would hold good, the Account using the proceeds of its sale of francs to buy treasury bills from the market.

There are, however, other possibilities. In the former of the two cases envisaged, the Account might sell treasury bills partly to the market and partly to the Bank of England; the increase in the credit base resulting from the Account's purchase of francs would only be partially neutralised, and an expansion of clearing-bank credit would follow. Or the Account, which as the result of the redemption of currency has large gold holdings, may sell gold to the Bank of England, using the proceeds to buy treasury bills in the market, thus inducing an expansion of credit. Thirdly, it must be remembered that treasury bills always mature within three months. Thus if the Account sells treasury bills to the market and these are not renewed when they mature, the banks are automatically put in funds. Fourthly, the Account may allow treasury bills issued to it through the tap to run off, and employ the proceeds to purchase gold in the market, with the result that bankers' deposits increase. The Exchange Equalisation Account has as yet not been

[1] There would, of course, be a decline in the cash ratio of the banks, due to an increase in deposits, bankers' cash being unchanged.

employed to limit the cash base of the banks, but there is little doubt that it could be so employed with equal effect. In short, there are open to the monetary authorities (and this to-day means the government more than the central bank) more numerous, more secret (for the transactions of the Account are not made public)[1] and more effective means of credit control than there were even six years ago.

Our study, however, is concerned with commercial, not central, banking, and we must consider the effect of these developments on the banks themselves. In the first place, the total volume of commercial bank credit is regulated from above. Secondly, the rates which the banks pay on deposits are determined for them; so, too, are the rates which they charge on an important proportion of their loans and discounts, though with limitations, as noted above. Thirdly, the composition of their assets is affected by central-bank policy. The "bills discounted" of the clearing banks consist mostly of treasury bills and their volume thus depends directly on the amount of bills which is made available to the market. At the same time the government and the central bank, working in co-operation, have demonstrated in the last five years their power to compel the clearing banks to purchase long-dated government securities, by expanding the basis of credit, and simultaneously reducing the supply of treasury bills, at a time when it was difficult for the banks to increase their loans and advances. This, in turn, between 1932 and 1936 was a factor in discouraging business men from borrowing from the banks, for the banks' large purchases of government securities caused the long-term rate of interest to fall and made it more profitable to borrow through the medium of new issues than on short term from the banks. In short, as a result of official policy there has come about, since 1931, a radical change in the distribution of the clearing banks'

[1] It was announced in July, 1937, that a statement of the gold held by the Account as at the previous 31st March and 30th September would be published every June and December.

funds among different kinds of assets. It may be added that, as a result of the shortage of trade bills and the employment of its funds in treasury bills, the discount market as a whole has placed itself in the hands of the central authorities. Nor is the government dependent on the banks in, for example, floating new issues. The banks may refuse to subscribe to an issue the terms of which do not satisfy them, but there are to-day a number of government departments, such as the Post Office Savings Bank, the National Debt Commissioners, the National Health and Unemployment Insurance Funds and the Exchange Equalisation Account, which, with the large funds at their disposal, can easily take up any part of a loan which fails to appeal to the general public.

The control of the monetary authorities is not confined to the methods mentioned above, nor to elaborations of them. The Macmillan Report made certain references to the " personal influence " of the Bank of England. That there is close contact between the Bank and other elements in the market such as the bill-brokers and issuing houses seems generally agreed, but the Report stated that " there might with advantage be closer contact between the clearing banks and the Bank of England ". There is reason to believe, however, that that contact is not slight, and that clearing-bank policy is becoming more and more closely bound up with that of the Bank, just as that of the Bank is even more closely bound up with Treasury policy. At a bankers' dinner at the Mansion House on 7th October, 1936, the Governor of the Bank of England made the following statement :— " Those for whom I speak welcome the freedom which we have in comparison with those in many other markets, but we wish to use that freedom in the only way it can be used, and that is, in harmony with the government's policy. I assure the Ministers that if they will make known through the appropriate channels what they wish to do in furtherance of their policies, they will at all times find us as willing with goodwill and loyalty to do

what they direct, as though we were under legal compulsion." To this statement by the Governor of the Bank of England may be added an extract from a speech by the Rt. Hon. Reginald McKenna, Chairman of Midland Bank, Ltd., at the dinner of the British Bankers' Association, 29th April, 1937 :—"We recognise in the Treasury and the Bank of England . . . the monetary authorities who have kept the pound sterling on a steady course through all the drifts, currents and storms of foreign exchanges. We welcome them as cordially as we bow willingly to their authority."

Examples of understandings between the commercial banks and higher authorities are the agreement of 1918 whereby a halt was called to the amalgamation movement, and the ban on foreign issues which was imposed in 1931. It appears also that in June, 1935, the Bank of England sent a circular to the banks and the bullion brokers, requesting them to co-operate in checking speculative forward dealings in gold.[1] In May, 1936, similar restrictions on the sale and purchase of gold coins at a premium are said to have been imposed.[2] One does not doubt that there are many other day-to-day matters not made public, in which the banks bow to the wishes of the monetary authorities.

The Standards of English Banking

Having reviewed the few requirements imposed by law on the English clearing banks, and the control exerted by the Bank of England and the Treasury, the reader is asked to consider in brief the standards by which the clearing banks have set themselves to carry on business. These practices are self-imposed and could be varied; nevertheless they do not in fact vary much, and it is convenient to have a criterion by which to judge the legal regulations of other countries.

[1] *Financial Times*, 11th June, 1935.
[2] *Financial News*, 20th May, 1936.

Capital and reserves

The ten English clearing banks (i.e. excluding The National Bank) had in December, 1936, a total subscribed capital of £246,161,000, of which £75,786,000 was paid up. Their balance-sheet total was £2,424,520,000, and the ratio of paid-up capital to total liabilities was thus 3·1 per cent., and that of subscribed capital just under 10 per cent. The ratio of paid-up capital is probably smaller than that ruling in other countries, though it is difficult to establish comparison with countries in which capital requirements are based on population. In theory it is the total of subscribed capital rather than paid-up capital which is significant in considering the protection afforded to depositors, but the extent to which shareholders would be in a position to meet calls is uncertain.

At the same time, reserve funds in December, 1936, amounted to £56,676,000, or about 75 per cent. of paid-up capital, a proportion much higher than is normally required by law elsewhere, except in the case of Japan and of American national banks. In addition it is believed that by means of the conservative writing down of premises and bad and doubtful debts, the banks have further "hidden reserves" of considerable value. A still further safeguard lies in the existence of special reserves for contingencies, which take the form of impersonal accounts and are included with deposits on the balance sheets of the banks.

Cash reserves

The cash reserves of the clearing banks taken as a whole vary between 10 and 12 per cent. of total liabilities, or are something like 20 per cent. of current accounts alone. This is higher than ratios in most other countries, though of course the ratio required of member banks of the federal reserve system, since it was raised in July, 1936, and again increased in January, 1937, is considerably above this. On the other hand, probably higher

reserve ratios are needed in England than in other European countries, where the cheque system is less developed and current accounts correspondingly less important. Even so, the ratio is higher than normal clearing and till requirements make necessary.

Liquidity

The outstanding feature of English banking is its liquidity. About 30 per cent. of a clearing bank's assets are normally in the form of cash, items in course of collection, money at call and bills discounted ; most of these items mature within considerably less than three months. Call money is always repayable within at the most seven days, and there is a market for bills (though English banks never in fact sell bills they have discounted) in all but the most stringent times.

The other two chief types of asset are investments and loans or advances. Investments are virtually all gilt-edged securities, in which there is always a market, though naturally very large quantities of government securities could only be sold at the expense of lowering their market value. Loans and advances, which are granted for periods not normally exceeding six months, are the least liquid asset, but these only amount at present to about 40 per cent. of assets, and at any one time there must always be a number of loans maturing. Thus, even as far as advances are concerned, a bank could always to some extent put itself in funds by refusing to renew old loans or to grant new loans as old ones were repaid. British banks never, as part of their policy, provide industry with long-term credit, as do German, and, to a less extent, Swiss and French banks.

Business in general

The English clearing banks do not usually own real estate other than premises ; that is to say, they sometimes in some of the bigger towns own large buildings, only parts of which are taken up by their own premises,

but they do not engage in speculative transactions in real estate.

An English bank may quite conceivably make a loan against the security of its own shares,—a procedure often forbidden elsewhere. As, however, for decades few shares have been more consistently highly valued than bank shares, there would appear to be nothing indiscreet in such a practice. Other difficulties which arise in a country of unit banks do not arise in England: for example, that of a bank lending a high percentage of its funds to one borrower. An English bank's funds are not only extremely widely distributed among different persons, but also among different industries and localities and over different maturities and types of loan.

English banks do not hold foreign exchange for their own account, except in very small quantities; they do not speculate in the exchanges. Apart from their small interests in subsidiaries they do not buy any but gilt-edged securities; nor do they buy and sell securities for speculative purposes.

The international acceptance operations of the joint stock banks have risen, since the Great War, to occupy an important place in their business, though naturally diminished to some extent in the last few years. Here again, however, their credits have been on the whole widely distributed between persons and countries, and they have made a practice of not normally accepting bills drawn in foreign currencies. Apart from the credits frozen in Germany since 1931, their losses have been small, and it is to be hoped that even the German credits may, eventually, not have to be accounted losses.

British joint stock banks never undertake the issue of securities, nor underwrite or take up new issues, nor do they own security affiliates or make themselves in any way responsible for the distribution of new issues. Loans are made by the banks at call to the Stock Exchange, but these only account for a very small proportion of their assets. There is thus never any possibility of any very

great proportion of an English bank's assets becoming frozen.

Inspection

In addition to the statutory audits of their central accounts, the English joint stock banks have their own inspection staffs and every branch is subjected to an examination, usually once a year. These examinations are always unannounced and are as thorough and detailed as any examination can possibly be. Any outside system of examination would be superfluous. It is perhaps in this matter that the advantages of a branch banking system are greatest. The unit bank manager has to conform to the requirements of the banking code; the branch manager has to answer to his head office. In certain cases he is bound to seek its advice or to pass matters on to it, and in case of difficulty he can always refer to it.

To sum up this chapter, English banks are subjected to a minimum of legal restriction. From the point of view of economic policy, however, they are under a considerable measure of control from higher financial authorities, while, from the point of view of practical banking, their own high standards and the expectations of the general public are a sure safeguard against any abuse of the great power which they wield.

ITALY

ITALY

Introduction

THE year 1926 marks a dividing line in Italian banking history. Prior to that year the banking system had been undeveloped and unorganised. The note issue was in the hands of three semi-state institutions, the Banca d'Italia, Banco di Napoli and Banco di Sicilia. The number of banks was large for a country of Italy's commercial importance—there were 223 institutions with a capital of more than one million lire registered at the end of 1926. Four of these controlled one-half of the total deposits of the commercial banks. Most of the leading banks combined deposit banking with long-term industrial financing. No system of supervision of commercial banks was in operation, but savings banks, pledge offices (*monti di pietà*) and rural and agrarian credit institutions were subject to the control of various ministries.

Under the legislation of June, 1926, the Banco di Napoli and Banco di Sicilia lost the right to issue notes, which was made a monopoly of the Banca d'Italia. By the so-called "Laws for the Protection of Savings" of September and November of the same year the commercial banks came for the first time under control, which was vested in the Banca d'Italia, as the newly created central institution, and in the Ministry of Finance. Under this legislation the Ministry of Finance maintained a register of banks, and the formation of new banks and the opening of branches by existing banks was made dependent on the consent of the Ministry in consultation with the Banca d'Italia. Foreign banks wishing to open

branches in Italy had to obtain permission from the Ministry of Finance, which took into account the treatment of Italian banks in the applicant's country. This seems an unscientific criterion, but is not uncommon in banking legislation.

Banks operating on a national basis were required to have a capital of at least 50 million lire, regional banks a capital of 10 million lire and banks operating in only one province a capital of 5 million lire. At least 10 per cent. of profits had to be carried to reserve, until it amounted to 40 per cent. of share capital. The share capital and reserves had to amount to at least 5 per cent. of deposits, and credit granted to any one customer was not to exceed 20 per cent. of a bank's own funds. For the purpose of control the Banca d'Italia was given powers of inspection, and bi-monthly balance sheets in a standard form had to be lodged with the central institution.

The Banca d'Italia was, in turn, made subject to close supervision by the Ministry of Finance. A special Inspectorate was created (the cost of maintenance of which was borne by the Banca d'Italia) whose function was to examine the balance sheets and compare them with the books, and to make a cash audit at least twice a year at the head office and at all the branches. To assist this Inspectorate an Advisory Commission was formed, presided over by the Minister of Finance, and consisting of three senators, three deputies and five other members appointed by the government. The Banca d'Italia was vested with most of the powers usually given to a central bank.

As mentioned above, the Italian banking system combined deposit and investment banking. Most of the leading banks were closely connected with industrial and commercial undertakings and some had formed subsidiary finance companies to link themselves up with the industrial concerns they controlled.

It will probably be agreed that such close association between banks and industry renders qualitative control of credit more difficult. For example, when credit has

to be restricted by the banks in response to central bank action it is not likely that strict impartiality in rationing credit will be observed as between the companies in which the bank has participations and those in which it is not interested. Undoubtedly the banking system incurs greater losses in times of general depression if the connections between banks and industry are close—losses which, in a highly developed capital market such as that of Amsterdam or London, fall directly on the individual investor.

These have been among the considerations underlying banking policy since 1926, which has aimed at ensuring that, as far as possible, different functions should be performed by different institutions. Some degree of functional differentiation was, of course, already present. The savings banks formed, in the main, a reasonably well-defined group and were subject to special legislation. This applied also to rural and agrarian credit institutions and to pledge offices.

The separation of long-term financing from deposit banking, which had still to be carried out, was hastened by the difficulties which have been experienced by Italian banking during recent years. Thus in 1930, when the Banca Nazionale di Credito was absorbed by the Credito Italiano, the industrial finance companies of both banks were merged into a new institution which took the name of the Banca Nazionale di Credito. With a view to facilitating such reconstructions the Istituto Mobiliare Italiano was formed by the government in 1931 to take over from the commercial banks their long-term advances to industry. Towards the end of 1932 the Istituto per la Ricostruzione Industriale was formed, also by the government, to provide permanent capital for industry, and also to take over frozen assets which the Banca d'Italia had acquired in the course of assisting a number of commercial banks. Banking in Italy during the past six years has thus had two characteristics—the separation of deposit from investment banking and the increase in control by the state.

The latter aim was emphasised by Signor Jung, the Minister of Finance, in his budget speech of May, 1933, when he stated that the general direction was towards an organisation that should be more and more " disciplined ". " In the conception of the Fascist Government this result could only be achieved through unity of direction, closed organisation, hierarchical graduation and discipline." [1]

It was not until three years later, however, that the next development in this direction took place. It is possible that the imposition of " sanctions " by member states of the League of Nations hastened the legislation of March, 1936, but in the main it must be regarded as a long-contemplated step along the path leading to a " disciplined " corporative state and the logical consequence of the various measures of the previous ten years.

Decree Laws of 1936 and 1937

On the 12th March, 1936, a law was enacted under the title of " A Measure for the Protection of Savings and for the Control of Credit ". After this measure had been in operation a year certain modifications became necessary, and a further Decree Law was issued on 17th July, 1937. On 23rd August, 1937, a Decree Law was passed which repealed the earlier measures and enacted a new law which differed from the old only on minor points of detail. The reasons for the changes are not sufficiently important to receive comment and the description given below is of the law as it stands at present.

As in the German banking legislation of 1934, no attempt is made to lay down detailed regulations. The Decree Law indicates the general scope of control and leaves the details to be filled in by administrative decree. It creates new controlling organisations (a Committee of Ministers and an Inspectorate), modifies the status of the Banca d'Italia, and provides for the regulation of com-

[1] Department of Overseas Trade, *Economic Conditions in Italy* (1933), p. 31.

mercial banks, of medium- and long-term credit institutions and of the capital market. The Law is thus of considerable importance—not that state action in any of these fields is new, but that for the first time the various parts of the financial system of the country are brought under the survey of one authority.

Organisation of Control

In its detail the organisation of control bears the imprint of the Fascist State, yet its general features are implicit in recent changes in banking policy and credit control in most countries with a highly developed financial system, irrespective of the particular political philosophy that is current. It is true that the need for having a credit policy at all is not often formally recognised in legislative enactments, yet it has now come to be regarded as one of the responsibilities of government. In Italy an organisation has been set up with the control of credit as its avowed object.

(a) *Committee of Ministers.*—The supreme control of the credit system is vested in a Committee of Ministers, presided over by the Head of the Government and consisting of the Ministers of Finance, Agriculture and Corporations. The co-operation of these ministries in the task of control is not new. For example, by a Decree Law of 16th July, 1905, the Ministries of Finance and Agriculture were made responsible for the supervision of land credit institutes, while the Istituto Mobiliare Italiano, formed in 1931, was placed at the outset under the control of the three ministries. To some considerable degree, therefore, the new legislation involves a simplification of existing regulative machinery and should make for increased efficiency.

The Committee is responsible for the general credit policy of the country and works in collaboration with the Central Corporative Committee, so that credit policy may be in harmony with other aspects of national life. It is also entrusted with the duty of supervising the system of

control which is administered by the Inspectorate. Thus it issues regulations governing the organisation of the Inspectorate, including the appointment of officials and the determination of their powers and duties. Regulations of the Inspectorate have to be approved by the Committee of Ministers and have then the force of law. The Decree Law provides that normally the Committee shall meet once a month, but in practice the intervals between meetings are sometimes as long as four months. On matters of urgency the Head of the Government is empowered to issue decrees, but these must be submitted to the Committee at its next meeting.

(b) *Inspectorate.*—The Inspectorate for the Protection of Savings and the Exercise of Credit [1]—to give it its full title—is a state organisation. The Head of the Inspectorate is the Governor of the Banca d'Italia and he is responsible for putting into effect the general policy laid down by the Committee of Ministers, as well as supervising the day-to-day inspection of commercial banks. He attends the meetings of the Committee of Ministers. The Inspectorate may demand information from all public departments and semi-state concerns, as well as from all the corporative organisations, and may call on them for assistance in carrying out its duties. Members of the staffs of government departments, of semi-state concerns or of banks are required to lend their services to the Inspectorate on request, the department concerned making the necessary arrangements.

All the banks and other bodies which come under the control of the Inspectorate contribute to its expenses—the basis of assessment being determined by the Committee of Ministers. An annual statement has to be presented by the Head of the Inspectorate to the Committee of Ministers for its approval. Appeals against the decisions of the Head of the Inspectorate may be made only to the Committee of Ministers.

[1] Ispettorato per la difesa del risparmio e per l'esercizio del credito.

(c) *Technical Corporative Credit Committee.*—To assist the Committee of Ministers in the examination of technical problems a new organisation—the Technical Corporative Credit Committee—was constituted by a Decree of 7th February, 1936, "to study the problems relating to the distribution, both functional and territorial, of credit institutions". The Decree Law of 23rd August, 1937, provided for the reconstitution of the Committee, and this was effected by a decree of the Ministry of Finance of 18th September, 1937. It now belongs to the Credit Section of the Corporation of Credit and Welfare. Its meetings are attended by officials of the administration designated by the Ministries concerned with the problems to be discussed. Experts may be invited by the chairman to give evidence. The first chairman of this Committee was the Vice-Chairman of Corporations; there are five other members, including the Governor of the Banca d'Italia and a professor of economics.[1]

(d) *Central Bank.*—It is not proposed to deal here with the constitution of the Banca d'Italia. It must, however, be mentioned that the Decree Law of 23rd August, 1937, leaves unchanged the strict supervision of the central bank by the Minister of Finance. Only three formal changes were made. The share capital was taken out of the hands of private investors and may now be owned only by savings and commercial banks, and welfare and insurance institutions. Supreme control was vested in the governor and fifteen directors, twelve appointed by the general meeting and three by the Credit and Welfare Corporation, instead of in the governor and seven directors, two elected by councils of the chief officers and five by the general meeting. Finally, no rediscounts may now be made on behalf of individuals or companies other than those under the control of the Inspectorate.

The retention by the Ministry of Finance of control

[1] Most other industries have similar committees to act in an advisory capacity on technical problems.

over the central bank, while the determination of credit policy is entrusted to the Committee of Ministers, seems somewhat anomalous, and the individual who is both Governor of the Banca d'Italia and Head of the Inspectorate would seem to have the unenviable task of trying to serve two masters. It must always be remembered, however, that in such circumstances the personality of the individual concerned is often of more importance than precise definitions of the scope of his authority.

Whatever theoretical balance of power may be inferred from the constitution of the various controlling bodies, it seems clear that in practice the Governor of the Banca d'Italia holds the key position. It is after hearing his opinions that the Committee of Ministers makes its decisions, and since he alone has the requisite technical knowledge it is likely that on all except the broadest issues of policy the Committee of Ministers merely endorses what he proposes. As Head of the Inspectorate he issues supplementary regulations and is thus in contact with and controls the actual day-to-day operations of the banking system. Finally, he is a member of the Technical Corporative Credit Committee, which is intended to act in an advisory capacity to the Committee of Ministers.

It seems likely that in future the Banca d'Italia will occupy a less important position in the scheme of credit control than that made familiar in orthodox central-banking theory. The vital measures of control will tend to be not merely movements of bank rate or open-market operations. They will take the form of regulations emanating from the Committee of Ministers through the Inspectorate, requiring such and such a ratio of certain assets, or fixing specific rates of interest on deposits or on loans. This change in the technique of control is not confined to Italy and the economic historian of the future may well mark the depression of the thirties as the beginning of the decline of the central bank as an independent institution. Credit is no longer thought of

as something that will automatically regulate itself if the central bank is given definite rules to apply in any particular set of circumstances, but as a function of government which has social and political as well as economic implications. Whether or not this is true, it seems clear that ideas similar to these underlie the legislation of 12th March, 1936, and 23rd August, 1937.

Scope of control

As already mentioned, control embraces the whole credit structure. "All concerns whether public or private which are engaged in the collection of savings from the public and in the exercise of credit functions are subject to the control of a state organisation created for that purpose, to be known as the Inspectorate."

This study is concerned with the control only of that part of the credit system consisting of the commercial banks, but before proceeding to an examination of control of commercial banking it is necessary to mention briefly the other parts of the credit structure which are subject to the same authority.

Control of the long-term capital market is achieved in two ways. The stock exchanges are brought under the control of the Committee of Ministers and the Inspectorate by the transfer of the strict powers of supervision previously exercised by the Ministry of Finance under a decree of July, 1932. Furthermore, all new issues of capital, whether in the form of shares, debentures or bonds, which are made through a bank or other credit institution subject to the control of the Inspectorate, or which are to be listed on any stock exchange in Italy, require the prior authorisation of the Inspectorate. No concern subject to the control of the Inspectorate may participate in placing any securities (other than obligations of, or guaranteed, by the state) without the Inspectorate's permission. Finally, to contract loans abroad, to take up financial participations abroad or to place foreign securities in Italy requires the consent of the Inspectorate.

Control of medium- and long-term credit institutions is vested in the Committee of Ministers and is exercised by the Inspectorate in accordance with instructions laid down by the Committee of Ministers. This includes control and supervision of land credit institutions, building societies, agricultural credit organisations and the special government-owned institutions such as the Istituto Mobiliare Italiano, Consorzio di Credito per le Opere Publiche, Istituto di Credito per le Imprese di Pubblica Utilità and others. Control in these fields is achieved in the main by a transfer of the existing powers of various government departments.

Control by the Inspectorate of the collection of short-term savings is effected in various ways: "the regulations are inspired by the fundamental principle of avoiding any undesirable rigidity arising from the application of the same rules to institutions with deposits running into milliards as to small rural savings banks. Having in fact established general rules governing the policy the Inspectorate is to pursue, and having defined its powers, the law leaves the chief part of regulation to the initiative and discretion of the Inspectorate as the organisation charged with enforcing the necessary control." [1]

The Decree Law of 23rd August, 1937, divides the institutions collecting short-term savings into six categories, viz.:—

(1) Public credit institutions and banks of national interest.
(2) Banks and credit institutions in general.
(3) Branches of foreign banks.
(4) Savings banks.
(5) Pledge offices.
(6) Rural and agrarian credit institutions.

The savings banks, pledge offices and rural and agrarian credit institutions were already subject to detailed regulation and supervision by various government departments,

[1] Rassegna Economica, May/June, 1936. *La riforma corporativa bancaria.*

and in so far as they are not inconsistent with the Decree Law of 23rd August, 1937, the decrees and laws governing these institutions remain in force, the powers previously granted to various ministries being transferred to the Committee of Ministers.

These, important as they are, fall outside the scope of a study of commercial banking. There remain the public credit institutions, banks of national interest, other deposit banks and, relatively unimportant, the branches of foreign banks operating in Italy.

Public credit institutions (*istituti di credito pubblico*) are banks which are under public ownership and control. Their boards of directors are nominated by the government or by provincial or municipal authorities, and their profits are assigned to public or charitable objects or added to reserves. The Banco di Napoli, Banco di Sicilia, Banca Nazionale del Lavoro and Istituti di S. Paulo di Torino were already public credit institutions and their status was confirmed by the Decree Law. The Monte dei Paschi di Siena—a land credit bank—was given the status of a public credit institution in 1936, so that there are now five institutions of this type. Their total deposits at the end of July, 1937, were over 7000 million lire.

Banks of national interest (*banche d' interesse nazionale*) are joint stock banks which have a widespread organisation of a national character and are recognised by decree. To be eligible for recognition a bank must have branches in at least thirty provinces.[1] The three largest joint stock banks, the Banca Commerciale Italiana, Banco di Roma and Credito Italiano, whose combined deposits are in excess of 14,000 million lire, have been recognised as banks of national interest under this provision.

The Decree Law of 12th March, 1936, provided that shares in these banks could be owned only by Italian subjects and that foreign shareholdings were to be repaid. In response to protests this provision was modified by a

[1] There are ninety-four provinces in Italy.

Decree of 23rd May, 1936, which was subsequently embodied in the Decree Law of 23rd August, 1937. Foreign shareholders were required to convert their shares into registered form. Those shareholders who did not so convert were repaid at a price established by the managing committee of the Rome stock exchange. Under a decree of 28th September, 1937, registration had to be effected not later than 31st December, 1937.

The articles of association of public credit institutions and banks of national interest have to be approved by decree of the Head of the Government on the proposal of the Committee of Ministers, which consults the Technical Corporative Credit Committee.

Formation

All commercial banking institutions require the authorisation of the Inspectorate before they can commence business ; their constitution has to be approved and they must comply with any requirements laid down by the Inspectorate with regard to minimum capital. If approved,[1] they are entered on a special register maintained by the Inspectorate, the register giving such details as the name, the legal form assumed, date of formation, share capital or endowment fund and reserves and a list of the branch offices and agencies. No permit to commence business may be issued unless the new bank is either a joint stock company or a limited partnership.

All authorised banks new and old must have their capital in registered form, although, with the special consent of the Inspectorate, bearer shares may be created provided that they do not carry more than 45 per cent. of the total voting power.

The words " bank ", " savings bank ", " credit ", " savings " and the like in the names of companies may be used only by concerns under the control of the Inspectorate.

By a decree of the Committee of Ministers of 16th May,

[1] Nine applications were made in 1936, three of which were successful.

1936, companies performing banking functions, although not strictly speaking banks, must file with the local branch of the Banca d'Italia details of their name, registered office and constitution, a description of their activities, together with a statement showing the amount of their share capital and reserves and a list of branches.

Branches

No branch or agency may be opened without the permission of the Inspectorate.[1] Originally applicable only to banks accepting deposits from the public, the scope of this provision has been extended by a decree of the Committee of Ministers of 16th May, 1936, to include all other banking concerns.

By a resolution of the Committee of Ministers, branches or agencies may be ordered to be closed either because they have proved inefficient or to improve the territorial distribution of banking facilities. If the latter is the reason, the Technical Corporative Credit Committee is to be consulted.

Capital

The Inspectorate is empowered to issue regulations regarding the relationship between capital and liabilities and the manner in which deposits accepted in excess of the amount to be determined by such relationship shall be utilised. A minimum capital for new banks may be prescribed. No regulations have so far been issued, and it remains to be seen whether or not the former practice of basing minimum capital on the geographical " spread " of a bank's branches will be maintained.

Assets

The legislation of 1936 and 1937 makes no specific provisions regarding the assets which a bank may hold, nor does it fix any proportions between the various classes of assets held. The Inspectorate is, however, empowered

[1] 103 out of 244 applications were approved in 1936.

to fix the proportion between the various categories of investments, both from the point of view of their liquidity and of their spread among the various branches of economic activity. So far, no regulations on this subject have been published. In banking circles the disadvantages of the introduction of rigid proportions are emphasised, and the view has been expressed that if any percentages are fixed, say, for the amount of credit which should be granted to different industries, they should be such as would give a reasonable margin for expansion or contraction.

The Inspectorate is further empowered to fix the relationship between capital and investments in real estate and shares. The issue of regulations relating to real estate was foreshadowed by a decree of the Committee of Ministers of 16th June, 1936. With a view to ascertaining the amount of real estate owned by banks and to checking any unjustifiable increases, all banks owning real estate or having participations in real-estate companies had to notify the Inspectorate not later than 30th September, 1936, of all real estate held. The returns had to show location, nature (whether urban, rural, industrial, etc.), cost, balance-sheet value, estimated market value, net income and whether subject to mortgages.

Since 16th June, 1936, all proposed purchases of real estate have had to be reported to the Inspectorate, and may be completed only if within ten days the Inspectorate raises no objections. The Inspectorate may request the gradual disposal of real estate not used for office accommodation if, having regard to the state of liquidity of the bank in question, this appears advisable.

The Inspectorate may fix maximum limits to the amount of credit which may be granted to any one person and in the event of these limits being exceeded may fix a period within which the position must be regularised. It was also empowered to require that applicants for credit should make declarations regarding their capital and economic position. Such regulations were issued on the 15th

September, 1936. They stipulated that all customers intending to borrow must file a detailed statement covering all their assets and liabilities. They apply to all types of bank loans over 25,000 lire, whether the borrowers be individuals, firms or companies.

Activities

Probably in no other country is the Inspectorate vested with such far-reaching powers of controlling the day-to-day activities of banks as in Italy. The powers would in fact seem limited only by the administrative difficulties which a high degree of regulation involves.

The Inspectorate is empowered to specify types of commitment which require its previous authorisation. These may be either of a general character or may apply only to classes of banks or to individual banks. By a decree of the Committee of Ministers of 1st May, 1936, the Inspectorate may also fix conditions relating to current and deposit-account operations and draw up scales of charges for various banking services.

Banks must maintain a book in which, in accordance with regulations issued by the Inspectorate, are recorded details of all credits granted. The particulars recorded must include the names of the officials proposing the granting of the credit. At a meeting of the Committee of Ministers of 16th June, 1936, a regulation was issued which defines precisely the official whose name has to be recorded. It reads as follows : "The description of proposer of a credit, where there are no officials to whom the duty of examining proposals for credits are expressly allocated, is to be applied to the official (or the officials or the head of the department) entrusted with the examination of applications for credit and with expressing his opinion, if only in a consultative capacity, in order to assist in the examination of the proposal by a deciding body. The description of proposer is, moreover, to be applied to the official who receives or obtains the request for credit and considers, within the limits of his authority, its acceptance.

Officials who propose credit operations are not, by reason only of having submitted proposals which are successfully consummated, to be considered as being charged with any responsibility other than that which officials normally assume at law by way of any responsibility arising from any specific operation." This regulation has been quoted in full as an illustration of the minuteness with which the internal affairs of banks are now regulated.

Interest rates

For some time past the rate of interest paid by banks has been fixed by cartel agreements. Under the auspices of the Banca d'Italia an agreement was made in 1932 under which the banks lowered the rates they allowed on current and deposit account. This agreement was not entirely satisfactory and there were constant complaints that it was not being adhered to. The Committee of Ministers accordingly issued a decree on 1st May, 1936, which made infringements of the banking cartel rates an offence. In general, since this date a rate lower than the official rate of discount cannot be applied either to discount operations or to advances on current account. The decree further made observance of existing cartel rates obligatory, pending the introduction of a new scale by the Inspectorate. It appears, however, that cartel rates are not always adhered to. "... Human nature being what it is, complete avoidance of violations may not be possible. In order to minimise such cases less by force of penalties and more by a sense of social duty, it would be useful to modify by some practical method the consequences of an evil which is already widespread. This might take the form of an adaptation to actual conditions by a reasonable modification of cartel rates, fixing an upper limit and allowing a certain elasticity in the downward direction."[1]

[1] Rassegna Economica, May/June, 1936. *La riforma corporativa bancaria.*

Officers

Directors, liquidators, managers and members of the committee of supervision are forbidden to have any business transactions with the banks with which they are associated, unless they are approved by a unanimous resolution of the committee of supervision and of the board of directors.

The Inspectorate is empowered to require that managing directors, partners, general managers, heads of departments and branch managers shall put up special guarantee deposits to be held in blocked accounts at authorised branches of the Banca d'Italia. These deposits may consist of shares in the bank in which the officials concerned are employed, or of government securities, securities guaranteed by the government, or title deeds to property. To augment these deposits, up to 3 per cent. of the officials' salaries may be deducted and invested half-yearly in securities of, or securities guaranteed by, the state, the securities so bought being added to the blocked deposits. The officials concerned have the right to decide in what government securities their deposits shall be invested.

The guarantee deposits so created are used to cover losses arising out of operations undertaken by officials *ultra vires.* They are released only after the expiry of one year from the date of resignation of the official concerned.

By a decree of the Committee of Ministers passed on 13th June, 1936, a schedule showing the amounts required from officials in different grades was approved, the scale being subject to a maximum of one-half the total remuneration received during the previous year. The blocked deposit has to be made up to the original amount if, by reason of a fall in security values, the market quotation of the securities deposited falls by more than 20 per cent. of the original valuation. Existing fidelity guarantees may be utilised. For managers with three or more dependent

sons the guarantee required is reduced by one-half.

No employee of the state or of state-owned institutions may hold office in any concern subject to the control of the Inspectorate, unless special permission is received from the Committee of Ministers.

No employee of any concern subject to the control of the Inspectorate may hold office as director, auditor or manager of any other company, but the Inspectorate may in special circumstances waive this rule.[1]

Where, in either of these cases, exemptions are granted, the fees received by the officials concerned have to be paid to the companies by whom they are employed.

Returns and inspection

Banks are required to make returns periodically. The form of the balance sheets and accounts and the dates for their preparation, publication and despatch to the Inspectorate are to be fixed by a decree of the Committee of Ministers. The supervision of the Inspectorate extends also to the non-banking activities of private credit concerns, even if from an administrative point of view they are distinct and separate, and such concerns are required to send statements and balance sheets in respect of non-banking activities in addition to the returns and balance sheets relating to their banking activities.

The Inspectorate may arrange for periodical and extraordinary inspections by officials empowered to call for the production of any documents which they may consider desirable for the carrying out of their duties.

All advertisements must indicate paid-up capital and reserves as shown by the most recent audited balance sheet.

Conclusion

It is scarcely possible to come to more than tentative conclusions about the newly instituted system of control —especially as for the most part the administrative regula-

[1] Decree of 1st May, 1936.

tions, which are to give body to the law, have not yet been issued. It may fairly be said, however, that a powerful controlling organisation has been created, which, if used fully, would make the Italian banking system a state organisation in all but name. To what extent the control will be used is a question only the future can answer, and that answer depends not a little on the success of the government in transforming the façade of the Corporative State into a living economic organism.

JAPAN

JAPAN

Introduction

ALTHOUGH a banking system in the modern sense of the term dates only from 1868, an elementary form of banking had long been practised in Japan. During the seventeenth century, for instance, the money changers were carrying on a business akin to deposit banking. They were, however, chiefly concerned with financing the government or important land-owning families of the samurai class and their activities were circumscribed by the social and economic rigidities of the feudal system.

The opening of the port of Yokohama to foreign trade in 1859, followed by the overthrow of the Tokugawa Shogunate and the restoration of the sovereign power to the imperial family in 1868, was accompanied by civil wars and considerable disturbance to economic life. The political and economic balance of power was changed, and in the process the financial institutions of the old order were overthrown.

The new government lost no time in reorganising the financial system. In 1869 a number of leading merchants received advances from the government in the form of notes amounting to two million yen with which to establish exchange companies. While filling the immediate need for some kind of banking facilities, these measures were hardly sufficient to form the basis for the financial system required for Japan's rapid economic development, and the success of the National Bank Act, 1864, in the United States, coupled with the fact that it was the most recent banking legislation in existence, made it natural that the

American code should be selected as a model for the establishment of a new controlled system in Japan.

National banking system

In 1872 the National Bank Regulations were issued. They provided for the liquidation of the exchange companies formed in 1869 and for the creation in their place of national banks with the right to issue notes convertible into specie. Each national bank had to deposit with the government paper money up to 60 per cent. of its share capital in exchange for which it would receive government bonds. Against these bonds the bank would issue its own notes. A specie reserve of 40 per cent. of share capital had to be maintained. However, as the government notes were at a discount, the national banks' notes soon disappeared from circulation. In fact, prior to 1876 only four national banks were opened and their total note circulation did not exceed 1,356,000 yen. One bank, indeed, had never been able to issue any notes at all.

In 1876 the hereditary feudal pensions of the nobility were capitalised by the issue of government bonds to an amount of 170 million yen. At the same time the original National Bank Regulations were revised, provision being made for the issue of national bank notes on the security of government bonds to the extent of 80 per cent. of share capital, and for the redemption of such notes in government paper currency instead of in specie. The measure proved popular and many feudal lords seized the opportunity of using their government bonds to form national banks. The number of national banks increased rapidly —between 1876 and 1880 148 new institutions were formed, compared with only four in the period 1872 to 1876. In numerous cases the banks were managed by persons who had had no previous banking experience and there was a rapid increase in the note circulation. The inflationary movement was accentuated by large issues of government paper money to meet the expenses incurred in quelling the Satsuma Rebellion of 1877.

By 1879 the maximum authorised note issue which the government had fixed at 34 million yen had been reached, but the results of the attempt to create a national banking system were hardly such as to encourage the government to extend the scope of national banking legislation. The condition of the currency demanded a thorough reorganisation and in the changes of 1882 and subsequent years the national banking system was destined to disappear.

Private banks

In addition to the national banks there were a number of private banks and financial institutions which had no note-issuing powers. In most cases they were firms which had carried on banking prior to the restoration and which had re-established themselves to meet the changed conditions of the new régime, and in this they had an advantage over the newer national banks which lacked the traditions of the old private bankers. Although precise statistics are not available, there were probably about 180 banks of this type doing business in 1882.

They were nominally subject to the supervision of the governor of the province in which they were situated, but no restriction was placed on their formation and the control exercised was neither uniform nor efficient.

Reform

The appointment of Prince Matsukata as Finance Minister in 1881 proved to be a turning-point, and it was during his twenty years of office that the foundations of the present banking system were laid. He enunciated two principles. The first was that the issue of notes and the manipulation of the exchanges in the interests of the nation's gold reserves should be in the hands of a central institution strictly controlled by the Minister of Finance. His second principle was that there should be distinct groups of banks, each group covering some particular field, such as long-term agricultural credit, industrial

finance, or the finance of overseas trade. He also believed that the government should control the activities of each of these groups in the interests of the nation.

In 1882 Prince Matsukata's first principle was put into practice by the formation of the Bank of Japan with a monopoly of the note issue. In the following year the National Bank Regulations were amended, the establishment of new national banks was prohibited and provision was made for the gradual redemption of the outstanding national bank notes and for the liquidation of all national banks by 1899.

The first step towards giving effect to Prince Matsukata's second principle was taken in 1890 when a commercial code on Western European lines was introduced. This was followed by the codification of the general banking laws in the Ordinary Bank Regulations, and by the promulgation of the Savings Bank Regulations, both in the same year.

Ordinary Bank Regulations of 1890

The banking code so created was of limited scope. It required that all banks should register with the Ministry of Finance, from whom they had to obtain a licence through the governor of the province in which they were situated. Reports had to be submitted half-yearly to the Ministry of Finance, which was empowered to order an examination at any time. No provision was made for regular inspection. There were issued, shortly after, Detailed Regulations for the Enforcement of the Banking Regulations, which defined the requirements of the Ministry of Finance in great detail.

Under these regulations, which became effective on 1st January, 1893, the remaining private bankers disappeared, a number of them registering under the new law as companies. In 1892 there were 323 ordinary banks in operation. The termination of the national bank system in 1897 caused an increase to 1305, many national banks re-registering under the Ordinary Bank Regulations.

The Ordinary Bank Regulations of 1890 remained the

basis of the Japanese commercial banking code for nearly forty years, although amendments were passed from time to time—the most important being those of 1895, 1900, 1916, 1920 and 1921. It is not proposed to examine these developments in detail as no fresh principles of regulation were introduced. In 1916, as a consequence of an amendment of that year which increased the supervisory powers of the Ministry of Finance, new Detailed Regulations for the Enforcement of the Banking Regulations were issued, replacing those issued in 1899.

Savings Bank Regulations of 1890

Banks whose main business was that of accepting savings deposits had existed for a long time and many national banks and private banks had their own savings departments. Under the regulations of 1890, however, the number of savings banks increased rapidly and by the end of 1901 there were 441 banks exclusively accepting savings deposits and 273 banks mainly concerned with savings deposits. The line of demarcation between a savings bank and a commercial bank was never clear and a number of banks organised under the Savings Bank Regulations carried on a commercial banking business. For this and other reasons the Savings Bank Regulations of 1890 had by 1921 become out of touch with existing conditions and a Savings Bank Act was accordingly passed, becoming effective on 1st January, 1922. As a consequence, 515 banks registered under the Savings Bank Regulations had to re-register as ordinary banks.

Special banks

Before passing to a detailed consideration of the regulations governing commercial banks, brief mention must be made of a number of special institutions which have played an important part in the Japanese banking system. In the main they deal with special types of financing and give effect to Prince Matsukata's principle of functional differentiation.

One of the most important of these is the Hypothec Bank of Japan, which was formed in 1897 with the object of making long-term loans at low rates of interest secured by mortgages on real estate. It obtains its funds partly by issuing debentures and partly by accepting interest-bearing deposits. The bank was intended to become the centre of a national system of mortgage banks, the formation of which was authorised in 1896 by the Agricultural and Industrial Bank Act. Between 1897 and 1900 one of these local banks was formed in each prefecture, but with the object of affording further assistance in agricultural districts an act was passed in 1921 permitting mergers between the local banks and the Hypothec Bank.

Attention was next devoted to industrial finance, and in 1900 an act was passed authorising the formation of an Industrial Bank of Japan. It obtains its funds mainly by the issue of long-term debentures although it also accepts deposits.

Meantime the needs of Japan's colonial empire were responsible for the formation in 1897 of the Bank of Taiwan to promote the economic development of the Formosan Islands. In 1909 the Bank of Chosen was formed to develop the Korean peninsula. Both banks have the privilege of issuing notes within their respective territories and act in a limited way as central banks. Two other banks have also been formed by the government to aid colonial development, Hokkaido Colonial Bank and the Oriental Development Company.

Finally the Yokohama Specie Bank deserves mention. Founded in 1880 under the National Banking Regulations, to foster Japanese overseas trade, the government issued special regulations to govern it in 1887. The state has been an important shareholder from the start, and, with government encouragement and protection, it has played an important part in the expansion of Japan's commerce.

These banks are known as special banks and are outside the range of the general banking legislation which

applies to commercial or "ordinary" banks. They are not on that account free from control, for in every case the legislation creating them provides for close supervision by the Ministry of Finance, a supervision which if anything is closer than that applied under the general banking code.

Trust companies

The development of trust companies in Japan has been in many ways similar to that in the United States, where companies originally formed to undertake trustee business have developed into banking companies. In Japan the transition has not been so complete, but it has at any rate been sufficient to justify here a brief description of trust companies.

The first company to undertake trust business—the Tokyo Trust Company—was formed under the provisions of the commercial code in 1904. During and after the War the number of such companies increased considerably and it became necessary to subject them to special regulation.

In 1922 a Trust Act and a Trust Business Act were passed, which gave the trust companies a new legal status, defined the scope of their business and subjected them to the control of the Ministry of Finance.

The business of a trust company is that of receiving, in trust, money, securities, claims, personal property and leases, acting as guarantor for debts, issuing securities, acting as custodian and handling dividend and interest payments, acting as intermediary in the selling or leasing of real estate and in the making of loans on real estate. Trust companies may subscribe to new issues, make loans to companies, public bodies and co-operative societies, deal in bills accepted by banks or trust companies, purchase any kind of property, real or personal, and deposit money with banks or with the postal savings office.

They are prohibited from undertaking a general banking business, but in fact money in trust differs little

from a fixed deposit with an ordinary bank. Trust deposits must be fixed for at least two years and the amount must be at least 500 yen, but there are no restrictions on the way the money so received is invested.

A trust company must be organised as a joint stock company and have a share capital of at least 1,000,000 yen. Before commencing business it must obtain a licence from the Ministry of Finance with whom government securities of an amount equal to at least 10 per cent. of share capital must be deposited as a guarantee fund. Reports have to be rendered periodically to the Ministry of Finance.

The banking crisis of 1927 gave rise to a general distrust of ordinary banks and greatly stimulated the growth of the trust companies, especially those connected with the Mitsubishi and Mitsui interests. In recent years, especially, they have tended to pay more attention to obtaining cash deposits than to the pure trustee business, and cash deposits fixed for long periods form the bulk of the funds they hold. They make long-term advances to public bodies and companies, and thus compete to some extent with the ordinary banks.

As will be seen later, the ordinary banks are forbidden to undertake trust business. Many banks have therefore organised trust companies of their own and at the present time most of the leading trust companies are affiliated to one or other of the larger ordinary banks. This is due not only to the fact that the pure trustee business has been profitable—as the English banks have also discovered—but also to the fact that the trust companies are able to offer higher rates of interest on long-term deposits as their assets are distributed with less regard for liquidity and they are thus able to earn a higher average return. As will be seen from the table on p. 287, the deposits of trust companies have grown during recent years and it may well prove necessary to redefine the relationship of the trust companies to the rest of the banking system.

The following table has been included in order to give some idea of the relative importance of the institutions described above :—

TOTAL DEPOSITS (IN THOUSANDS OF MILLIONS OF YEN)

31st December :	1929	1930	1931	1932	1933	1934	1935	1936
Ordinary Banks .	9·2	8·7	8·2	8·1	8·7	9·4	9·9	10·9
Special Banks .	1·2	1·2	1·2	1·3	1·3	1·3	1·4	1·5
Savings Banks .	1·4	1·5	1·6	1·7	1·8	1·9	2·0	1·8
Postal Savings .	2·1	2·3	2·6	2·7	2·8	2·9	3·1	3·4
Trust Companies .	1·2	1·2	1·2	1·2	1·4	1·6	1·7	1·8
	15·1	14·9	14·8	15·0	16·0	17·1	18·1	19·4

Bank Act of 30th March, 1927

The Savings Bank Act of 1921 which has already been mentioned was intended to be the first step in a reorganisation of the whole banking system. The depression of 1920–21 had revealed weaknesses in the financial system which responsible opinion held should be repaired as soon as possible. Unfortunately there was little attempt made either by the banks or by industry to adjust their finances, and the earthquake disaster of 1923, by concentrating energy on the more pressing tasks of emergency relief, diverted attention from the more fundamental task of economic reorganisation, and helped to perpetuate the unsound financial structure inherited from the post-War boom.

By 1926 the time appeared ripe for a thorough examination of the Japanese financial system, and in September of that year the Financial System Investigation Commission, appointed on the model of the National Monetary Commission of the United States of America, started its work of inquiry.

The Commission was under the chairmanship of the Minister of Finance and consisted of 40 members, of whom 7 were government officials while the remaining 33 included leading bankers, stockbrokers, representatives

of trust companies, members of the Diet and financial experts. It was charged with the examination of the following matters :—

(1) measures to enable the Bank of Japan to function more efficiently as a central bank ;
(2) the improvement of the ordinary banking system ;
(3) the development of the discount market and securities market ;
(4) the improvement of the savings banks and trust companies ;
(5) the facilitation of the granting of credit to agriculture and industry, foreign trade, colonisation, etc. ;
(6) the extension of banking institutions for the working classes ;
(7) measures to reduce the rate of interest.

Reform of the ordinary banking system was discussed first, and the Commission's recommendations were presented in November, 1926. These recommendations were embodied in a new Bank Bill which was passed with little amendment on 30th March, 1927.

The need for reform was evident and indeed, while the measure was being discussed in the Diet, a financial crisis was developing rapidly. During February and March of 1927 the uncertainty as to the renewal of "earthquake bills" which the banks had had to take up led to a number of runs on smaller institutions. Finally, in April, 1927, the Bank of Formosa was forced to close owing to a run precipitated by the failure of the firm of Suzuki. The crisis forced a change of government and it became necessary to declare a moratorium from 22nd April to 12th May, 1927. A number of banks suspended payment ; some were reopened later with the aid of credits from the Bank of Japan.[1]

Coming as it did at a time of widespread distrust of

[1] For a full account of the crisis see the Department of Overseas Trade Report on Economic Conditions in Japan to 30th June, 1928.

the banking system, it is rather surprising that the Bank Act made so few innovations. It is notable for its omissions rather than for the stringency of its positive provisions.

Application of the act

The act applies to all institutions, Japanese or foreign, carrying on a banking business in Japan proper, Taiwan (Formosa) and Karafuto (Japanese Saghalien). A Japanese bank whose head office is situated outside those areas — for example, in Korea, Kwantung Province (leased territory) or in a Chinese port where Japan has extra-territorial rights—is subject to the act in so far as it has branches within Japan, but is treated almost as though it were a foreign bank, and in the following pages such institutions are designated quasi-foreign banks.

A bank is defined as an institution carrying on the business of—

(1) receiving deposits together with lending money or discounting bills ;
(2) dealing in exchange.

The acceptance of deposits is sufficient to bring a company within the scope of the act. This definition replaces the somewhat curious phraseology of the 1890 Regulations, which provided that concerns "which, in premises open to the public and as a business, discount securities or carry on exchange business or accept deposits as well as grant loans", were all "banks" irrespective of the name they bore.

No other activity may be carried on, except the issue of debentures under the Secured Debentures Trust Act, the acceptance of valuables for safe custody or other subsidiary activities which are usually carried on by banks, such as collecting bills, undertaking guarantees and buying and selling securities for customers. Such activities must, however, be kept subordinate to the

pure banking side of the business. The same restrictions apply to foreign and quasi-foreign banks; in addition they are prohibited from issuing debentures under the Secured Debentures Trust Act. Prior to 1927 a bank could carry on other business provided it obtained a permit from the Ministry of Finance through the local governor, and it is perhaps surprising that it had been possible for so long to combine banking with other businesses.

Formation

Under the Ordinary Bank Regulations of 1890 there were no restrictions on the legal form which a bank might assume, and banking could be carried on by an individual, partnership, limited partnership or joint stock company, there being banks in each of these categories. The Bank Act of 1927, however, required that banks should be organised as joint stock companies—a requirement that is becoming increasingly common in commercial banking legislation. The act does not form a complete code, but is read in conjunction with the commercial code, which regulates the corporate existence of banks as joint stock companies.

The bank's name must contain not only the words "joint stock company" as provided by the commercial code, but also the word "bank". Companies which are not banks may not use a title which implies that they carry on a banking business.

If a bank wishes to change its name, written application has to be made to the Ministry of Finance, the documents to be filed being a statement of the reason for the change and a copy of the minutes of the shareholders' meeting at which the change was approved.

Having been organised in accordance with the provisions of the commercial code, a bank has then to make a written application for a permit to commence business, signed by all the directors, which has to be submitted to the Ministry of Finance, together with such documents

as the articles of association, a list of the names and addresses of subscribers and the number of shares taken by each, and a list of branches and places of business. If, having received a licence, the bank does not commence business within six months, the licence automatically becomes void, unless the delay has been unavoidable and the Ministry of Finance has granted an extension. On commencement of business the Ministry of Finance must be notified.

Where a foreign or quasi-foreign bank wishes to operate in Japan, a written application from its head office must be made and a local representative appointed for each branch. The application has to be accompanied by notarially attested copies of such documents as its certificate of incorporation and articles of association and balance sheet. In granting a licence the Ministry of Finance may place specific restrictions on the bank's activities, the object of this provision being to apply to the foreign bank the same treatment as a Japanese bank would receive in the foreign bank's country.

Establishment of branches

A permit from the Ministry is required to establish new branches, sub-offices or agencies, to change their location or to convert sub-offices into branches. In such cases written application has to be made to the Ministry of Finance accompanied by a statement of the reasons for the proposed changes and a copy of the minutes of the shareholders' meeting at which they were approved. Where a branch is to be established a copy of the daily statement must be furnished and in the case of a new agency, the contract of agency. A permit so obtained must be made use of within six months of the date of issue; otherwise it becomes void, unless the Ministry of Finance grants an extension. Agencies may not form sub-agencies.

Branches, sub-offices or agencies may be closed by mere notification to the Ministry of Finance of the date

of closing, the reason for closing and the measures taken for dealing with deposits.

Similar provisions apply to foreign and quasi-foreign banks. Where a foreign bank having more than one branch discontinues business at one of its branches, the Ministry of Finance may require the business of the discontinued branch to be taken over by another branch.

Amalgamations

As early as 1896 an amendment was passed to facilitate bank amalgamations and in 1920 a further amendment was introduced waiving certain of the provisions of the commercial code. Thus banks, as joint stock companies, are not required to notify their depositors individually when amalgamating. Furthermore the two months' prior notification by public announcement required for joint stock companies is reduced to one month in the case of a merger and the usual three months' period during which shares of the merging institutions may be transferred is also reduced to one month.

An amalgamation requires the consent of the Ministry of Finance and a written application has to be made, accompanied by such supporting documents as the minutes of the shareholders' meeting at which the amalgamation was approved, the contract of amalgamation and the articles of association of the surviving bank.

As has already been mentioned, prior to 1927 the line of demarcation between commercial banks and savings banks was by no means clear. Provision was made in that year, however, to enable ordinary banks to merge with savings banks engaged in commercial banking business, with the aim of ensuring that savings banks should limit their activities to their proper sphere. (Ordinary banks, however, as in most other countries, still accept savings accounts.)

It is not untrue to say that it has been the policy of the government almost from the promulgation of the Ordinary Bank Regulations to encourage the amalgama-

tion movement, and at frequent intervals the government has taken steps to reduce the number of independent institutions. This factor, working together with the economic and financial development of the country, which has tended towards the creation of larger units, has produced a notable diminution in the number of independent institutions.

Figures published by the Ministry of Finance give some idea of the extent of the consolidation movement in the Japanese banking system :—

Year	Number of Ordinary Banks	Deposits (in Millions of Yen)
1905	1697	693
1910	1618	1186
1915	1442	1700
1920	1326	5826
1925	1537 *	8379
1930	779	8687
1935	463	9864

* The increase in the number of banks is due to the promulgation of the Savings Bank Act of 1921, which compelled many banks registered under the Savings Bank Regulations of 1890 to re-register as ordinary banks.

Capital

The banking regulations of 1890 made no positive provisions regarding capital. It was sufficient to report the amount of the bank's capital to the Ministry of Finance when applying for a licence and to report any subsequent changes. The Savings Bank Law of 1921 required that savings banks should be formed as joint stock companies with a share capital of at least 500,000 yen, and when the Ordinary Bank Act was passed six years later a minimum capital was also fixed for ordinary banks.

Normally the minimum capital is 1 million yen, but this requirement is doubled in the case of those banks which have either their head office or any of their branches in districts designated by Imperial Ordinance, and in November, 1927, the two largest cities of Tokyo and

Osaka were so designated. Japan has thus adapted the American principle of relating the size of capital to the population of the centre in which the head office of a bank is situated.

Japanese banks formed outside Japan proper, Taiwan and Karafuto, if they wish to open offices and carry on business within those areas, must be formed as joint stock companies with a capital of at least 1 million yen (or 500,000 customs taels for those whose capital is fixed in silver currency and whose head offices are in China). These minimum requirements are doubled if the banks operate within the designated areas of Tokyo and Osaka.

Foreign banks are not required to have any specific capital, for it is clear that any such provision would be of little use as a safeguard to Japanese depositors. Hence minimum capital requirements are replaced in the case of those companies by the obligation to deposit approved government or other securities to the value of 100,000 yen for each branch or agency opened. If a valuation of the securities at the end of any half-year shows that their value is below 100,000 yen, additional securities must be deposited. This limit would appear to be too low to afford any appreciable security. There are 7 foreign banks operating in Japan, having in all 15 branches.

A reduction or increase of capital requires the consent of the Ministry of Finance.

Directors and managers

Directors and managers actively engaged in the conduct of the bank's daily business may not take charge of another business without the sanction of the Ministry of Finance. In such a case full details have to be filed, including a personal history of the person concerned, his exact duties in the bank and the position he proposes to occupy in the other company, the articles of association and accounts of the company and a description of the type of business, if any, conducted between the bank and the company in question. These restrictions do not call for

any special comment; similar restrictions, in many cases more detailed, are a common feature of banking legislation in all countries.

Accounts

On the payment of any dividend at least 10 per cent. of the profits must be carried to reserve until reserves equal share capital. The principle is the same as that embodied in the commercial code, which requires of joint stock companies the transfer of 5 per cent. of profits until the reserve amounts to one-quarter of the share capital.

In accordance with usual Japanese practice balance sheets and accounts must be presented half-yearly, the accounting periods being January to June and July to December. The accounts, which must be filed with the Ministry of Finance, include a report of the board of directors, a balance sheet and profit-and-loss account showing the amounts placed to reserve and distributed as dividend, and a detailed statement regarding the cash reserves. A standard form is set out in the Detailed Regulations (Finance Department Order No. 31) of 17th November, 1927, and the accounts have to be filed within one month of the end of the half-year to which they relate.

The balance sheet, which forms part of the report mentioned above, must be advertised in the press and the advertisement must contain the names of the directors and auditors.

In accordance with the provisions of the commercial code the half-yearly accounts must be audited. In addition the Bank Act requires that the auditors prepare twice in each half-year a report giving the results of their auditing of the assets and condition of the bank. The report, in a standard form prescribed by the Ministry of Finance, must be filed at the head office of the bank, within one month of the expiry of the quarterly period to which it relates.

Activities

Japanese commercial banking legislation places no restrictions on the type of assets which a bank may hold. Banking codes in many other countries contain elaborate rules governing the way in which a bank invests the funds entrusted to it by its depositors and the proportions which the various classes of assets bear to the total. In Japan, as in England, the banker is free (within the limits imposed by custom and public opinion) to invest his funds where he will. There is nevertheless a conventional distribution of assets which the larger banks at any rate adhere to, and which is as stable as that found in many of the countries where highly elaborate rules are prescribed.

Not only are there no statutory requirements with regard to the assets held by ordinary banks, there are also no statutory ratios governing the relationship between capital and liabilities on the one hand and cash reserves and liabilities on the other. Here again there is a tendency to adhere to conventional proportions.

Finally there must be noted a complete absence of any provision designed to remedy the lack of co-operation between the central bank and the ordinary banks. There is no requirement that the ordinary banks shall maintain balances at the central institution or conform to changes in the Bank of Japan's discount rate.

Examination

To undertake the day-to-day supervision of banks and the examination of the various reports filed periodically, the government created in May, 1927, a special department of the Ministry of Finance known as the Bureau of Banking of the Finance Department, with a staff of 18 bank examiners, 54 assistant examiners and the requisite secretarial assistants.

In addition to the reports and accounts regularly filed by the banks, the Ministry of Finance is empowered to require a bank at any time to submit reports on its busi-

ness or produce certificates of inspection or any other documents required. The examiners and members of their staff may examine the books and records of the bank at any time.

In addition to the requirements already mentioned, a bank must report immediately to the Ministry of Finance in any of the following events :—

(1) Amalgamation with another bank, or acquisition of the business of another bank without amalgamation.
(2) Change in the personnel of the directors or managers and the relinquishing by a director or manager of a position in another company.
(3) Alteration, termination or renewal of an agency contract.
(4) Adjudication in bankruptcy or making a composition with creditors.

General powers of the Ministry of Finance

Enforcement of the Bank Act of 1927 is in the hands of the Ministry of Finance, which is endowed with very wide powers.

If the Ministry considers that the condition of any bank warrants such action, it may order the suspension of its business or the deposit of any part of its assets with the authorities.

If any order of the Ministry is not obeyed, if any of the provisions of the Bank Act, Ordinances or Detailed Regulations are infringed, or if a bank commits any act "calculated to prejudice public welfare", the Ministry may order it to suspend business, replace any or all of the directors or auditors, or cancel its licence.

These powers place the Ministry in a position to enforce conformity with the law and do not call for any special comment.

Central-bank control

All the principal banks maintain accounts with the Bank of Japan, but the balances they keep are very

small and are probably little more than the amounts required to meet clearing differences, which under the rules of the various clearing houses are settled through the local branch of the Bank of Japan. The total inadequacy of the balances as a reserve will be appreciated from the fact that the total of "private deposits" at the Bank of Japan (which include deposits of private customers as well as those of ordinary banks) amounted at 31st December, 1936, to less than 1 per cent. of the ordinary banks' deposit liabilities.

The banks are indeed almost always indebted to the central institution, and look to it as the "lender of last resort" in times of crisis, but this dependence has not been used by the Bank of Japan to impose its discount policy on the market. As a former Finance Minister of Japan [1] has justly said, "The official discount rates of the Bank of Japan have little relation with market rates, which always anticipate the former. The change in the official rates has therefore taken place more for the purpose of acting as a warning signal than by reason of an established discount policy."

This lack of co-operation between the various elements of the financial system has made it difficult to carry out a consistent monetary policy, especially when deflation was required. The weakness is in part due to the conflict often apparent in Japanese life between the industrialist and the financial interests. The situation has been ably described by an English economist [2] who has made a special study of Japanese conditions. He says, writing of the monetary policy of the years 1920 to 1925 :—
". . . it should not be forgotten that a large part of the modern industrial and commercial enterprise of Japan is in the hands of a few great business families whose interests are wide enough to embrace almost every kind

[1] Tadao Wikawa in *Foreign Banking Systems* (Parker Willis and Beckhart, p. 863).

[2] G. C. Allen, *The Recent Currency and Exchange Policy of Japan*, Economic Journal, March, 1925.

of economic activity, including banking. Thus there is not the same clear-cut division between financial and industrial interests in Japan as in England, and some of the greatest joint stock banks of the country such as the Mitsui and the Mitsubishi represent only one part of the business activities of those houses. It is obvious that the attitude of such firms towards the country's financial policy would be determined by industrial rather than by purely financial factors, and that the weight of their influence (which is considerable) would be thrown against any policy which might intensify the industrial depression. . . . Even if the Government had decided to adopt a deflationary policy it is extremely doubtful whether, in view of the weakness of the central bank, there would have been sufficient co-operation among the financial institutions of the country to make such a policy effective. For instance during the past few years repeated protests have come from high officials against the practice of the ordinary banks of advancing loans on the security of real estate and other fixed assets, on the ground that such transactions should be left to the semi-official Industrial and Hypothec Banks which were formed specially for that purpose. Such protests have apparently been quite ineffective in preventing the smaller joint stock banks from accumulating assets which are impossible to realise in times of financial difficulty."

Conclusion

It has been said by a well-known Japanese economist [1] that the characteristic feature of the Japanese banking laws is their liberality. Banking is not looked upon, as it is in so many European countries, as business of a class apart,—almost of a public nature. A bank is treated in the main as any other commercial institution which operates for profit. While, therefore, such measures of control and supervision as have been imposed are based largely on American models, the public attitude towards

[1] Gijoju Odate in *Japan's Financial Relations with the United States.*

banking is more akin to the British outlook. No legal regulations exist as to the type of asset which a bank may acquire; nor are there statutory reserve ratios or provisions relating capital to liabilities. These omissions are noteworthy because in a country such as Japan, where branch banking is relatively undeveloped, a much greater degree of regulation might have been expected.

Not only is there little statutory regulation, there is also little effective control by the central institution, for although in times of crisis the Bank of Japan has always acted as a lender of last resort, it has seemed unable to impose its policy on the market for more than short periods.

It is the opinion of competent observers that two reforms are necessary. First, the standards of banking of the smaller banks must be raised and the quality of their assets improved. This might be accomplished either by the introduction of more detailed legal regulations or by an amalgamation movement resulting in the elimination of the smaller and weaker banks. Secondly, the influence of the Bank of Japan should be strengthened so that control over the constituent elements of the money market becomes more complete. A practice of maintaining larger reserve balances with the central bank would be of considerable help in this direction, while further amalgamations, already referred to above as desirable for other reasons, would facilitate that personal contact between the central institution and the commercial banks which seems so essential to the pursuit of any monetary policy.

NORWAY

NORWAY

Introduction

It is characteristic of the Norwegian banking system that it is composed for the most part of a large number of banks, each serving a relatively small community and each independent of the other. To a large extent this is the normal development in a country where difficult communication combines with a strong local patriotism, and where wealth and natural resources are small in relation to area.

The early development of the savings banks is also characteristic. Dependent for the most part on forestry, agriculture and fishing, Norway's economic structure demanded long-term capital in small amounts for a rural population rather than great concentration of capital for highly capitalised industrial processes. In such conditions the savings banks tended to be more important, compare dwith the commercial banks and the stock exchange, than was the case in highly industrialised countries such as Belgium. Christiania Sparebank was formed as early as 1822, from which time the movement made steady progress. By the end of the century the number of savings banks had increased to over 400.

The development of commercial banking accordingly came late. Norges Bank was founded in 1816 (two years after the separation of Norway and Denmark), but it remained the only joint stock company undertaking a commercial banking business for over thirty years, Christiania Bank og Kreditkasse being founded in 1848. From that time onwards a number of institutions were formed, and by 1910 there were 102 banks with total deposits of about 450 million kroner.

Stimulated by the inflation experienced in the War years, the number of banks increased considerably (there were 22 new banks formed in 1917 and 40 in 1918), so that by the end of 1920 the number of banks was over 200 and deposits were well over 3000 million kroner. The new institutions were not always under prudent management and competition between old and new banks led to the growth of unsound practices.

Control and supervision of commercial banking were absent, for the Bank Inspectorate formed in 1900 was responsible only for savings banks. Banks organised in joint stock company form had to comply with the law relating to joint stock companies, but it contained only a few regulations of minor importance relating specifically to banks.

The dangers inherent in the system were recognised as early as 1918, when a temporary measure was passed making the formation of new banks and the increase of capital of existing banks subject to government sanction.

A permanent basis for regulation had, however, to be found, and to this end a committee was appointed by the Minister of Finance early in 1919. This committee reported a year later, but current events made immediate action impossible.

The expansion of the War and immediate post-War years had been mainly in the form of nominally short-term credits to those branches of industry, such as shipping and fishing, which were most sensitive to world conditions. The depression of 1920–21 thus caused grave difficulties in the banking system. The weakness became evident in 1921, when a number of the smaller banks failed, and when, in the following year, two of the largest banks had to be assisted, the government was forced to act. On 24th March, 1923, the Public Administration Law was passed. Its object was to enable banks in difficulties to continue in business by giving new depositors prior claims in the event of subsequent liquidation. In the case of two of the banks which took advantage of this measure, Andre-

sens og Bergens Kreditbank and Centralbanken for Norge, the government guaranteed all new liabilities for a limited period. In July, 1925, the Public Administration Law was replaced by a permanent measure which provided that no further banks should be placed under public administration after 17th July, 1928.

The more urgent problem of the insolvent banks having been met by the Public Administration Law of 1923, the government was free to concentrate on measures of permanent control of the system as a whole. After considerable discussion in which both Norges Bank and the Norwegian Bankers' Association took part, a Bank Act was passed on 4th April, 1924, and became effective on 1st January, 1925.

If the authors of the Bank Act of 1924 hoped it would prevent future bank failures they were doomed to disappointment. The international crisis of 1931, although it hit the Norwegian banking system only indirectly, gave rise to withdrawals of deposits for hoarding purposes, and on 15th December, 1931, Bergens Privatbank and Den Norske Creditbank suspended payment. A three months' moratorium was declared, the government issued an order giving priority to all new liabilities, and after a capital reconstruction it was possible to lift the moratorium on 15th March, 1932.

These were not the only institutions to suspend payment : altogether seven commercial banks were similarly affected between December, 1931, and July, 1932.

Although the progress of the movement towards control has been largely determined by the banking crises mentioned above, it would be wrong to assume that control is merely a product of banking difficulties. In a country with a large number of scattered unit banks some uniformity of practice must be enforced, if the central authorities are to fulfil their task of regulating money and credit. As the Banking Committee's Report to the Storting aptly said, " this Committee's draft Bank Act is based on the main consideration that joint stock banks

perform a function in society which, more than that of any other private enterprise—more for instance than trade, shipping or industry—has a semi-public character ".

In the succeeding pages the main provisions of the Bank Act of 1924 will be outlined and the system of control created by this and subsequent measures examined.

Formation

The Act of 1924 applies to " all undertakings which procure means for the working of their business in the form of deposits from the public ", with the exception of Norges Bank and other banks formed under special legislation, savings banks and co-operative societies. Only those undertakings subject to the Bank Act have the right to call themselves banks.

Banks must be organised as joint stock companies with limited liability and must issue a prospectus and offer their capital for public subscription. With the permission of the Crown, three or more Norwegian banks may form a bank without the issue of a prospectus or a public offer of shares, but so far no banks have been formed in this way. Except where a bank is formed by existing banks as above, it must have at least ten shareholders who are Norwegian subjects resident in Norway. Furthermore, if any shareholder is not a Norwegian subject the fact must be reported to the Inspector of Banks. Persons other than Norwegian subjects may hold up to one-tenth, and with the permission of the Crown, up to one-fourth of the share capital.

The name borne by a bank or its branches must not be identical with or resemble that of any other Norwegian bank, nor may it include the word " savings " or convey the impression that it is the national bank. A register of names is kept by the Inspector of Banks.

No bank may be registered until it has permission from the Crown to commence business. Permission may be refused, not only if the bank's articles of association contain provisions contrary to the act or regulations issued thereunder, but also if the capital is not deemed

to be sufficient for the activities proposed or if the formation is not considered to be in accordance with public interest. Norges Bank is entitled to state its opinion as to the advisability or otherwise of granting the permit. Permission once granted may be rescinded if the board of directors, the management or officials of the bank have infringed any regulations of the act or of the bank's articles of association or if the activities of the bank are deemed to be contrary to public interest. That obtaining a permit is no mere formality is shown by the experience of Samverkebanken A/S, which was formed in 1932 under the auspices of the Norwegian Co-operative Society with a capital of 1,600,000 kroner. Attempts were made in 1932 and 1933 to obtain permission to commence operations, but it was not until December, 1935, that it was granted.[1] It appears that in this particular case the delay in granting permission was due partly to political considerations.

Branches

Branches may be opened only within the municipality in which the registered office is situated, unless the permission of the Crown has been obtained.

Foreign banks may open branches in Norway provided that Norwegian banks have the same right in the country in question. Such branches have to submit to such requirements as are deemed necessary by the Crown to safeguard the interests of their Norwegian customers, and in every case must have a separate board of at least three persons, all of whom must be Norwegian nationals resident in Norway, and also a special committee of control consisting of three persons appointed by the Inspector of Banks.

Capital and surplus

The capital of a bank must be at least 400,000 kroner, but in special cases where only a small local business is

[1] *Norwegian Joint Stock Banks*, December, 1935.

contemplated the Crown may sanction a lower capital, provided that it is at least 100,000 kroner. Permission is required to increase or reduce the share capital or to issue irredeemable income debentures, which for most purposes are regarded as capital.

Repayment of share capital which would reduce capital below 400,000 kroner or whatever limit has been fixed is not permitted, but reductions in capital may be made to meet losses so long as the capital remains at least 100,000 kroner. Without permission from the Inspector a bank may not acquire its own shares for cancellation.

All shares in a bank must have the same par value, which must not be less than 100 kroner. The consideration must always be cash except where, with the permission of the Crown, mergers between banks take place by an exchange of shares. Registration of a transfer must be refused if it would result in foreign holdings being above the fixed quota. A bank may not be registered until at least one-half of the face value of each share has been paid up, and where the capital is increased, at least one-half of the new capital must be paid up within one year. The whole of the share capital must be paid up within two years.

Before any dividends can be distributed one-fifth of the annual profits have to be transferred to a reserve fund, until the reserve amounts to one-half of the share capital. At the end of 1936 there were still a number of banks whose reserves had not reached the statutory level.

In order to ensure that a bank's own resources are sufficient to provide a margin of safety for depositors, the Bank Act stipulates that total liabilities must not exceed ten times share capital and reserves. Total liabilities include liability on rediscounted bills payable in Norway, but exclude liability under guarantees. The total liability of a bank under guarantees is restricted to 75 per cent. of its share capital and reserves. In special circumstances the Inspector of Banks may waive this limit, but in such

cases the amount must be reduced to the stipulated limit within a year. These restrictions do not apply to certain mortgage bonds, to documentary credits or to guarantees which are secured by deposits at the bank in question or by securities which are eligible as reserves.

Individual banks differ greatly as to the proportion of capital to liabilities which they maintain, but most have a comfortable margin.

Management

(a) *The Board of Directors.*—The board of directors must consist of at least three members and all must be Norwegian subjects, unless special permission is given. The managing director may not engage in any other business nor be a member of the board of another company. In certain circumstances, however, an exemption may be granted by a two-thirds majority of the board of directors. No member of the board or manager of a branch may vote on a question of granting a loan or discounting bills for his own account or for account of a company of which he is a member.

Under the law of July, 1923, amending the constitution of Norges Bank, no director or member of the branch management of another bank may be a member of the supervisory council, board of directors or branch management of Norges Bank without the consent of the board of representatives.

Apart from this, however, there do not exist any restrictions on interlocking directorates, and the express provision for banks owning other banks through shareholdings would seem to indicate that the authorities did not wish to discourage the practice of grouping the weaker banks around larger and more powerful institutions.

A bank may not grant loans to any of its own directors, nor to a company of which he is a responsible member or of whose board he is a member, except on the security against which loans may be made in excess of 25 per cent. of the bank's own capital and reserve (see p. 315),

and which has been approved by the committee of control. Loans may not be granted on the endorsement or guarantee of one of the bank's directors or of a company of which he is a responsible member. Trade bills are excluded from these limitations.

(b) *The Board of Representatives.*—The board of representatives consists of at least seven members of whom three-quarters are chosen by the general meeting from among the shareholders, and one-quarter by a meeting of depositors from among their own number. This representation of depositors is probably unique, and was introduced at a time when banks were under criticism. The presence of depositors' representatives cannot, however, be said to have given depositors any real measure of control, as, quite apart from the fact that they command only a quarter of the votes of the board of representatives, the functions to be performed by the board are largely formal.

It is the function of the board of representatives to examine the accounts and to appoint auditors. The auditors have to carry out the proper auditing of the books and balance sheets, verify the cash and securities and if necessary check the work of the permanent audit staff. They make their report to the board of representatives through the committee of control.

(c) *The Committee of Control.*—The committee of control consists of at least three members elected by the board of representatives from among its members. They hold office for one year. Members of the committee of control have to keep in touch with the bank's work and have access to all records and correspondence. Once a year the committee reports to the board of representatives and to the Inspector of Banks.

(d) *The General Meeting.*—In order to ensure that a bank's affairs should not be dominated by a majority or large minority of shareholders, the Bank Act provides that at a general meeting no one shareholder may vote more than one-tenth of the total votes applicable to the share

capital or more than one-fifth of the votes represented at the meeting.

Liquidation and amalgamation

Regulations affecting the liquidation and amalgamation of banks do not call for detailed comment, but the chief provisions may be noted.

If, as shown by its audited balance sheet, a bank has lost 25 per cent. of its share capital, the board of directors must inform the board of representatives, the chairman of which has to advise the Inspector. A general meeting must then be called to decide whether or not the bank shall continue in business. A two-thirds majority holding at least one-third of the voting capital is required, for a decision to continue the business to be valid, and new capital to the amount that has been lost must be subscribed (or guaranteed) before the close of the meeting. If it is decided to transfer the whole of the business to another bank, a simple majority vote is sufficient, but the transfer requires the consent of the Crown. Finally, the meeting may decide that the bank shall be liquidated. In default of any decision the Inspector reports the case to the Probate Court, which appoints liquidators.

The provisions outlined above do not prejudice the right of a creditor to petition the Court to place the bank in bankruptcy. This right is, however, somewhat limited by the authority given to the Crown to grant at its discretion a three months' moratorium to a bank which finds itself in difficulties. The utility of this procedure was demonstrated in December, 1931, when withdrawals of deposits led to the suspension of payments by Bergens Privatbank and Den Norske Creditbank. The respite so obtained enabled fresh capital to be provided and both banks were able to resume payments at the end of the three months' period.

Activities

The Bank Act of 1924 contains no precise definition of banking. In its report the Banking Committee on whose

work the act is based said: "It appears to be impossible to give a logical definition of the business which the joint stock banks may carry on—a definition which is satisfactory from a legal point of view and which at the same time provides a safe guide in all doubtful cases".

In practice the usual concept of banking is sufficient to settle most borderline cases. To afford some guidance the act specifies certain typical banking operations, but it must be noted that the omission of any particular activity does not thereby make it outside the province of a bank's business.

Banking business includes :—

1. Receiving deposits, subject to definite notice of withdrawal or on current account,—the name, occupation and residence of the person for whom the deposit is held to be stated.
2. Granting loans and credit on bills and other acknowledgments of debt, and in the form of credit on current account, documentary credits and letters of credit.
3. Acting as intermediary in the case of loans or credit granted by others, guaranteeing and underwriting the sale or subscription of bonds and shares offered to the public.
4. Buying and selling bills, cheques, bonds and other money instruments, foreign coin, notes and gold and silver in bars.
5. Buying and selling shares and real estate for the account of others.
6. Storing valuables and securities, recovering debts and making payment for the account of others.

A business other than banking may be carried on only temporarily and to such an extent as may be necessary to recover debts. Pawnbroking may be carried on with the consent of the Crown.

The general conditions on which deposits are received must be displayed in the bank or otherwise made public in

a manner approved by the Inspector of Banks, and he has to be advised when, in special cases, deposits are accepted from private customers on terms which differ from those published.

Reserves

Like the banks in other Scandinavian countries, Norwegian banks have always had a large proportion of their liabilities in the form of savings and time deposits, and in recent years there has been keen competition with the savings banks for new accounts. Thus savings accounts and time deposits account for 80 per cent. of total deposit liabilities. This explains the low reserve ratio fixed by the act. The proportion of cash (i.e. till money and balances with Norges Bank) is not prescribed, but a reserve of " liquid means " has to be kept, which, together with cash in hand, amounts to at least 20 per cent. of the bank's sight liabilities and at least 5 per cent. of the bank's total liabilities, excluding liabilities under guarantees. Certificates of indebtedness, which rank after ordinary liabilities, may be excluded with the consent of the Crown.

" Liquid means " are defined in detail. They include net demand deposits with banks, both Norwegian and foreign, which is in accordance with Scandinavian practice, as is the inclusion of securities issued by or guaranteed by the government, bonds of counties or approved municipalities, obligations of Norges Kreditforening for Land-og-Skogbruk (Norwegian Credit Association for Agriculture and Forestry) and of De Forenede Norske Kreditforeninger (United Norwegian Credit Association). Municipal securities and those of the above-mentioned credit associations must not exceed 10 per cent. of the reserve of liquid means, and bonds of a single municipality 5 per cent. of the reserve of liquid means. Finally foreign government bonds, whether quoted in Norway or not, may be included.

If the reserve of liquid means falls below the limit, the bank is allowed three months in which to restore the

statutory ratio. Otherwise the matter has to be reported to the Inspector of Banks, who then stipulates a further period of grace.

To those accustomed to think in terms of English practice this list has several interesting features. There is no bill market in Oslo, and the amount of outstanding treasury bills is small. Consequently call money and treasury bills, the English banks' second line of defence are absent, and their place is taken by government and similar securities, and demand deposits with other banks.

The principle of requiring a higher reserve against demand deposits than against time deposits is sound. As elsewhere, however, the attempt to enforce sound practices by means of laws is not always entirely successful, and in Norway this requirement has been materially weakened by the practice of allowing customers to draw cheques on savings accounts (which rank as time deposits), thus making them equivalent to current accounts.

Assets

As a general rule banks may not buy and sell shares for their own account. Shares, however, may come into the possession of a bank, either through its having to take over shares lodged as security or through its having underwritten a public issue of shares which was not fully subscribed. In these cases the bank must dispose of the shares as soon as it can do so without loss : shares taken up in respect of underwriting contracts must, however, be sold within three years, unless the Bank Inspectorate grants an extension for special reasons. As an exception to the general rule stated above, a bank may invest in shares up to 20 per cent. of its share capital and reserves, while shares in banks may be acquired without limit, subject to the permission of the Crown being obtained.

Real estate, or shares in companies formed to develop real estate, may be acquired only to the extent of 10 per cent. of capital and reserves, and then only in so far as they are required for premises. If real estate has

been acquired by foreclosure, it must be sold as soon as the amount of the debt can be recovered.

With a view to preventing banks from operating indirectly in shares and real estate, the Bank Act limits shareholdings in investment and finance companies to 10 per cent. of a bank's capital and reserves, and provides that a bank may not vote more than 10 per cent. of the total votes cast at any general meeting of such companies.

The banks themselves have recently shown a tendency to regard long-term finance as being outside their sphere. In August, 1935, the chairman of the Norwegian Bankers' Association stated that Norwegian industry relied too much on the banks for long-term credit and that such credits should be granted by special institutions. In July, 1936, A/S Den Norske Industribank was accordingly formed with a capital of 10 million kroner, 51 per cent. of which is in " A " shares held by the state and 49 per cent. in " B " shares subscribed by the banks. The state guarantees a 4½ per cent. dividend on the " B " shares, and has the right to take them over at par after ten years. The bank may raise loans by issuing state-guaranteed bonds up to a maximum amount of five times its share capital. Similar organisations have been formed in a number of countries during recent years, and it may be that they will play an important part in the capital market, and cause the gradual abandonment of the mixed banking system which is found in so many European countries.

In most countries with a unit banking system experience has shown the danger of an institution lending too large a proportion of its funds to one customer. The Bank Act accordingly restricts the amount which a bank may advance to any one borrower to 25 per cent. of its capital and reserves, this being subject to a number of qualifications which in effect exempt advances made on unquestionable security. Thus loans made in the following manner are not subject to the 25 per cent. limit :—

(1) Mortgages on real estate up to one-half of its taxable value.
(2) Mortgages on ships up to one-half of "normal value".
(3) Loans on securities which are eligible to be included in the liquid reserve.
(4) Documentary credits.
(5) Self-liquidating trade bills.

The amount of credit granted includes liabilities under guarantees and, in the case of a company, the book value of shares held by the bank in that company.

The operation of the 25 per cent. limit has caused certain difficulties in financing the seasonal requirements of the whaling industry through the local banks, but there can be no doubt but that the rule has proved a useful check.

When loans granted to any one borrower amount to 20 per cent. of share capital and reserves, the matter has to be reported to the committee of control.

On a unanimous decision of the board of directors the 25 per cent. limit may be exceeded "when absolutely necessary", but the Inspector has to be advised immediately and the amount reduced within a year.

Inspectorate

As in other countries, it was found advisable for purposes of control to set up a special organisation—the Inspectorate. Created by the law of 5th March, 1900, under the name of Controller of Savings Banks, it assumed its present status under the Bank Act of 4th April, 1924, the Savings Bank Act of 4th July, 1924, and the Acts for the Joint Inspection of Joint Stock Banks and Savings Banks of 11th August, 1924, and 24th May, 1929.

The Inspectorate is in charge of an Inspector, who is assisted by five sub-inspectors and a secretariat. The Inspector is a state official appointed by the Crown. His staff is appointed by the Ministry of Finance. Nominally, at least he is independent of the Ministry of Finance, as

his salary and those of his assistants are fixed by the Crown with the consent of the Storting. To maintain the impartiality of inspection, officials of the Inspectorate are not allowed to be employed by, or to take part in the management of, a bank, and they are subject to the same limitations regarding loans as are directors.

The various matters which, under the Bank Act, have to be decided by the Ministry of Finance, must be submitted to it by the Inspectorate, while on the other hand the Inspector has to advise the Ministry of Finance on any banking problems which they submit to him. He sends an annual report to the Ministry of Finance, and the statistics collected by his department are published by the Central Statistical Office.

The Inspector is charged with the duty of seeing that the banks conform to the requirements of law and of assisting them in its interpretation. His staff has access to all the records and books of the banks and must be furnished with any information that may be required. He has the right—

(1) to order banks to keep their books and prepare their annual accounts and balance sheets in accordance with special rules drawn up for the purpose ;
(2) to draw up rules for the publication of the annual accounts and balance sheet, together with auditor's certificate ;
(3) to draw up rules requiring banks to send in extracts of accounts at stated periods, together with information as to interest paid on deposits and rates of interest, discount and commission on loans ; and to send in such information as may be found necessary for statistical purposes. Accounts and information are to be published by the Inspector of Banks to such extent as may be found expedient ;
(4) to require banks to send in such other statements and information as may be found necessary for

the due performance of the duties of the Inspector of Banks ;

(5) to draw up a standard form for deposit receipts and bank-books (passbooks) ;

(6) to order boards of directors and boards of representatives which have acted contrary to law or failed to carry out their duties in accordance with the law or their articles of association, to take the necessary steps to regularise the position ;

(7) to call meetings of boards of directors, committees of control and boards of representatives, when considered necessary ; to be represented at such meetings and at general meetings, and to bring forward proposals without, however, casting any vote. In the event of a board of representatives failing to comply with the Inspector's demand to call an extraordinary general meeting, such general meeting may be called by the Inspector of Banks himself ;

(8) to report any breaches of the provisions of the act to the police authorities.

The act provides that appeals against decisions of the Inspector may be referred to a permanent council of five members appointed by the Crown, provided that permission to appeal has been granted by the Ministry of Finance. So far no bank has made use of its right to appeal.

The costs of inspection are covered by annual contributions from banks in proportion to their total liabilities at the end of the preceding year, provided that no bank contributes less than 75 kroner nor more than 15,000 kroner. Contributions are levied by the Inspector subject to the approval of the Ministry of Finance.

Central-bank control

One of the most important kinds of control over commercial banks is that exercised by a central institu-

tion ; yet in most countries the extent of that control is undefined by statute and depends on what is little more than a series of tacit understandings. The most obvious instrument of control, namely, bank rate, is fully effective only if a convention or law governs the relationship between the central bank's discount rate on the one hand and on the other the rates charged by the commercial banks on advances and allowed on deposits.

Such a convention exists in Norway, though it is not as strong as it is in England. In an address given on 19th February, 1934, the Governor of Norges Bank was able to say that " with the close relations existing in Norway between the discount rate, the deposit rate and the rate on advances, the rates charged by the banks have been brought down to a level which compares very favourably with other countries ".[1] The connection between bank rate and loan and deposit rates is strengthened by the cartel agreements between the banks themselves. The rates applied have to be reported to the Bank Inspectorate, though the Inspectorate is not empowered, as in Italy and Germany, to compel banks to adhere to cartel rates, and its influence is limited to moral suasion.

In the early part of 1934 considerable pressure was brought to bear on the government by the farmers and the labour party for cheaper credit, and the Inspector made repeated requests to the banks for reductions in mortgage rates. The larger banks responded, but a number of banks, particularly savings banks, took no action. The government accordingly passed on 29th June, 1934, a temporary act authorising the Ministry of Finance to make orders concerning the rates of interest applied by joint stock banks and savings banks. It is perhaps of interest to quote the act in full :—

" Art. 1. After having obtained the opinion of the Bank and Savings Bank Inspectorate, and subject to the conditions indicated in Art. 2, the Ministry

[1] *Norges Bank Monthly Report*, February, 1934.

of Finance may order a joint stock bank or savings bank to reduce the rates of interest and commission applied to certain kinds of advances or to specified advances.

Art. 2. Such an order may be issued only if the rates and commission in question are above the level generally adhered to by the same kinds of banks (joint stock banks or savings banks), and provided that special circumstances are not present to justify the employment of higher rates. The order will apply to current advances on the earliest date on which notice of repayment may be given.

Art. 3. Prior to the decision of the Ministry of Finance, the joint stock bank or savings bank in question, Norges Bank, Den Norske Bankforening, Centralforening for Norges Sparebanken, and the local banking organisation (if any) must be given the opportunity of expressing their opinion within a time limit fixed by the Ministry of Finance in each separate case.

Art. 4. If an order given under this act by the Ministry of Finance to the board of directors of a joint stock bank or savings bank is not complied with, the Ministry of Finance may order the terms to be amended subject to a daily current penalty. This penalty may be enforced by execution."

In fact, the procedure provided for in the act has never been applied, for, soon after it was passed a number of banks whose rates might have been regarded as above the average level reduced them voluntarily. In any case the measure must be regarded more as a political manœuvre to satisfy certain sectional interests than as a permanent incursion on the part of the government into the field of control of interest rates.

Besides the discount rate, open-market operations may form an important means of central-bank control. Such operations may be in securities, in bills or in advances, but

for various reasons Norges Bank has only engaged in such operations to a limited extent. Until June, 1936, some doubt existed as to whether the central institution was empowered to buy and sell securities, but in that month an amendment was made in the Norges Bank Act expressly authorising such operations. The comments of the Governor at the annual meeting of Norges Bank on 17th February, 1936, on the limitations of open-market policy are worth quoting :—" At the same time we should not close our eyes to certain defects of our securities market which limit to a considerable extent the possibility of conducting operations of this kind. We may at times make purchases, but it is difficult to sell securities in large amounts, because the market is so limited, and to drive down security prices may produce harmful subsidiary consequences."

The narrow securities market is a greater drawback, in that there is no bill market such as exists in London. In May, 1934, the government was authorised to issue treasury bills with a tenor of up to six months, to a maximum amount of 40 million kroner, but this form of borrowing does not seem to have gained any great popularity.

Some mention should perhaps be made of the control of the foreign exchange market which was put into operation soon after Norway's departure from the gold standard on 27th September, 1931. This does not rest on any legal basis, but is a matter of voluntary co-operation between importers, the banks and the central institution.[1] A good example of this is seen in the warning issued early in 1934 by the Norwegian Bankers' Association and Norges Bank against orders for new tankers being placed abroad too freely. Broadly speaking, however, the smoothness of the control system is due to the fact that the Norwegian krone is not seriously over-valued in terms of other currencies and that the restrictions are at present largely formal.

[1] *Norges Bank Monthly Report*, February, 1935.

Conclusion

Norway was the last of the three Scandinavian countries to adopt a banking code, and it is therefore natural that in its construction the experience of neighbouring countries should have been drawn on. In general the same principles are followed as in Sweden and Denmark, with such modifications as are required in a country of unit banks. Thus minimum capital is fixed at a much lower level than in Sweden, where a branch banking system is well developed. Legislation has in the main been directed towards the enforcement of minimum standards, and it has undoubtedly been successful in remedying the more obvious faults which were in part responsible for the bank failures of 1922 and 1923. In recent years, however, there has been a tendency to introduce legislation in response to pressure from sectional interests which happen to be politically powerful—a tendency which, if extended, might have adverse effects on the banking system and on the whole community.

SWEDEN

SWEDEN

Enskilda banks

THE first bank to be established in Sweden was a private institution, formed under a charter dated 30th November, 1656. It was authorised to deal in exchange and to grant loans. In 1668 it was placed under the control of the Riksdag and became in effect a state bank, although it did not assume the title of Riksbank until 1867.

During the eighteenth century various attempts were made to meet the growing need for banking accommodation by forming institutions subsidiary to the Riksbank, but these were not successful. The question occupied public attention in the early years of the nineteenth century, and finally a royal decree was issued in 1824 authorising the establishment of private banks, known as enskilda banks.

Before a bank was granted a charter (which was valid for ten years and could be renewed) its articles of association and the regulations for the conduct of its business had to be approved by the Crown, which required to be satisfied that the regulations and the funds available were appropriate to the business the bank proposed to undertake. In every case a declaration was made that the bank would not receive any funds from the state and that the state would not be called upon to make any contribution towards maintaining the bank or rescuing it, if it found itself in difficulties. The objects and the constitution of the bank were to be advertised in the Official Gazette in the same way as those of other new companies, it being made clear that the shareholders were jointly and severally liable for its debts.

The banks were authorised to make loans repayable within a year, and a maximum legal rate of interest was fixed; any loan not repaid at maturity carried interest at a rate fixed by the discount agency of the Riksbank.

The right to issue notes was not expressly mentioned in the 1824 legislation, but, except in the case of the first two banks formed, the issue of notes was provided for in the charter or in the articles of association of each bank. The question of note issue aroused considerable public discussion, and in a royal decree of 1846 the enskilda banks were specifically empowered to issue notes under certain conditions.

What is perhaps more interesting is that the enactment provided that the subscribed capital of each bank should amount to at least 250,000 silver dalers (1,000,000 dalers currency). Of the amount subscribed at least 10 per cent. was payable in cash before the bank commenced business, and a further 15 per cent. within a year. Security for any unpaid capital had to be deposited under official charge in a safe controlled jointly by a public official and by the bank. The security so deposited could take the form of money, gold and silver bullion, mortgages on real estate or bonds or shares of industrial companies (but not shares of enskilda banks) approved by the Crown. This idea of depositing security for unpaid capital was not altogether new, as similar provisions had been made in the articles of association of some of the banks formed under the 1824 measure. Reduction of capital was not permitted.

The articles of association, which had to receive the approval of the Crown before a charter was granted, dealt with such matters as management, audit, general meetings and regulations governing the way advances were made and deposits accepted.

Banks were forbidden to trade in commodities other than gold and silver, but property held as security for loans might be taken over on the understanding that the bank realised as soon as it could do so without loss.

They were authorised to issue non-interest-bearing notes payable to bearer on demand, interest-bearing obligations payable either to bearer or to order in denominations of not less than 500 currency dalers, and deposit receipts payable to specified persons.

The banks were required to report their position quarterly to a local official of the Crown, who was entitled to appoint an inspector to examine the returns and to inquire into their affairs at any time. The Crown could cancel a bank's charter in the event of serious breaches of the law.

Considerable expansion took place in the note circulation of the enskilda banks after 1846, and further regulations followed in 1855, which fixed the minimum number of shareholders at thirty and redefined the activities which a bank might carry on. Henceforth banks were forbidden to own real estate not required for their own use. Whereas loans could previously be made for a period of a year, the new law fixed six months as a maximum. On such loans interest at 5 per cent. might be charged, 6 per cent. being permitted on loans in arrears.

A new era in enskilda banking was opened by the formation of Stockholms Enskilda Bank in 1856. In contrast to the other enskilda banks, which obtained most of their funds from the issue of notes, this bank aimed at the outset at attracting deposits which it invested in short-term loans, and its success in this field induced its competitors to work on similar lines.

The charters of the enskilda banks had been renewed in 1856 for ten years, and before their expiry a new measure was passed (in 1864). Apart from provisions regarding note issue there were a number of important innovations. A special class of shareholders, with limited liability, was now permitted, provided that the amount of share capital of this description did not exceed one-third of the total share capital. The new shares were freely transferable, unlike the ordinary shares, which could not be transferred without the assent of a general

meeting. A new provision stated that if the annual audit showed that 10 per cent. of a bank's ordinary capital was lost, the bank was to liquidate, unless at a special general meeting the amount lost should be subscribed. Directors were required to hold at least one share and could only retire with the assent of the general meeting.

Ten years later the law was again revised. A new section made obligatory the filing of monthly statements with the Ministry of Finance, instead of quarterly statements as required by the 1846 Act. The growing work of inspection necessitated the appointment in 1877 of an Inspector of Banks, attached to the Ministry of Finance.

In 1879 the 5-kronor notes of the enskilda banks were withdrawn by agreement with the Riksbank, and in 1897 legislation was passed giving the Riksbank a monopoly of the note issue. By the end of 1903 all the enskilda banks had discontinued the issue of notes, which ceased to be current after the end of March, 1906.

It now became necessary to redefine the position of the enskilda banks, and by the Bank Act of 1903 the issue of notes payable to bearer on demand was prohibited. The act introduced no new principles of control, but was important in that it gave a more precise definition to a number of points which under the old law were obscure. Thus the use of the words " enskilda bank " in the bank's official title was made compulsory, if the share capital was above 1,000,000 kronor ; if less, the words " folk bank " had to be used. The use of the word bank was restricted to enskilda banks, savings banks and joint stock banks. The law also elaborated provisions for inspection.

Joint stock banks

Meanwhile the advantages of forming joint stock banks with limited liability, but without the right to issue notes, had not been overlooked. The question aroused considerable attention in the early sixties and a draft measure was submitted to the Riksdag in 1862, but

failed to become law. In the following year, however, the first joint stock bank with limited liability was formed under a general companies act of 1848. In succeeding years several such banks were formed, but it was not until 1886 that they were made subject to comprehensive regulation.

The Bank Act of 1886 provided for the grant of charters for periods of twenty years to joint stock banks with limited liability. The shareholders, numbering at least twenty, were required to be Swedish subjects. Minimum capital was fixed at 1,000,000 kronor, although where the articles of association provided for only a localised area of operation the capital might be less, subject to an absolute minimum of 200,000 kronor. At least 20 per cent. of the capital had to be subscribed in cash and security given for the remainder, before the bank could commence operations. Within three months a further 20 per cent. had to be paid up, and the balance within a year. At least 15 per cent. of profits were to be transferred annually to reserve until reserves amounted to one-half of share capital.

Joint stock banks were prohibited from carrying on any business other than that of dealing in gold and silver, bills of exchange and interest-bearing securities. They could neither acquire their own shares nor lend money on the security of them. Real estate might be owned only in so far as it was required for premises or had been taken over to protect a loan: in the latter event it had to be sold as soon as the bank's debt could be repaid in full out of the proceeds.

The growing importance of deposit banking as compared with note issuing led to a rapid growth in the number and size of the joint stock banks: by 1900 there were 40 joint stock banks compared with 26 enskilda banks.

With the abolition of the note-issuing rights of the enskilda banks there was no longer any justification for applying different regulations, and simultaneously with

the Bank Act of 1903 relating to enskilda banks, a Bank Act relating to joint stock banks was made law. Apart from the provisions relating to shareholders' liability, this was identical with that applying to enskilda banks. Henceforth, for all practical purposes, the distinction between enskilda banks and joint stock banks disappears.

Bank Act of 1911

The international crisis of 1907 came after Sweden had experienced a considerable expansion in banking facilities. The financial system withstood the shock well, although the banks incurred considerable losses and one institution was forced to reorganise.

Nevertheless the crisis caused fresh attention to be given to the problem of banking control and a comprehensive measure was finally made law in 1911. Two new principles were introduced. There was firstly the principle of relating share capital to liabilities and, secondly, that of requiring that a certain proportion of a bank's sight liabilities should be invested in liquid assets. These provisions will be dealt with later under their respective headings.

The Bank Act of 1911 forms the basis for the present regulation of Swedish banking, although there have been numerous amendments, the most important being those of 1918, 1919, 1928, 1933 and 1934.

Unlike banking laws in certain other countries, the Swedish law is self-contained and does not have to be read in conjunction with other laws such as the law relating to ordinary joint stock companies. A large part of the Bank Act is therefore devoted to regulating the existence of a bank as a legal entity. Such provisions have no particular relevance to a study of banking control and will not be dealt with in the following pages.

The act is divided into six chapters. The first deals with banks formed as joint stock companies with limited liability, the second with banks with shareholders' liability unlimited. The third chapter deals with the

inspection of banks, the fourth with registration. Penal and miscellaneous provisions are contained in chapters five and six respectively.

Under the Bank Act of 1911 commercial banking might be carried on by three types of organisation: individuals or partnerships, enskilda (or *solidariska*) banks, and joint stock (or *aktie*) banks.

Private banking firms were not subject to any of the provisions of the act, except that they were not allowed to use the word "bank" in the name of the firm. Prior to 1914 they had indeed played a relatively unimportant part in the financing of trade and industry. With the expansion of business activity due to War conditions, however, banking became extremely profitable, and a large number of private banking firms was founded. It was felt that depositors of such firms had no adequate protection, and in 1918 a Bank Act was passed which restricted the right to accept deposits from the public to enskilda banks, joint stock banks or banks formed under special legislation.

The enskilda bank in its turn was destined to disappear. It had played a useful part in the development of the financial system during a period when note issue was a primary function of commercial banking. That justification for its separate existence disappeared in 1903. By this time, too, opinion in Sweden, as in England, had accepted the view that limited liability has practical advantages which offset the theoretically greater protection which unlimited liability appears to give. In fact no new enskilda banks were formed after 1893 and the succeeding forty years saw a gradual diminution in their number. By 1934 unlimited liability had become an anachronism and in the Bank Act of that year provision was made for the conversion of the remaining enskilda banks into joint stock banks.

The position is now that commercial banking is restricted to joint stock banks and the provisions described in the following pages are those relating to such banks.

Formation

As has already been seen, the permission of the Crown has been required, from early times, before a banking company could commence business. The procedure under the Bank Act of 1911 is for the promoters of a bank, who must be Swedish subjects resident in Sweden and must number at least ten, to submit draft articles of association. If the formation of the bank is considered to be in the public interest, the articles of association are examined, not only to see that they conform to the Bank Acts and the general law of the country, but also to see whether and to what extent special regulations are desirable, having regard to the scope and nature of the business which the bank proposes to conduct. The articles submitted usually follow a model drawn up by the Inspector of Banks. If the articles are approved, the Crown grants a charter for a period of ten years, and this may be renewed for successive decennial periods. It is only rarely that a bank has failed to obtain a renewal of its charter—there has been no instance within recent years. This must on the whole be regarded rather as a tribute to the sound practices pursued by Swedish banks than as an indication that the law is ineffective.

Amalgamation and the opening of branches

Branch banking developed early in Sweden, although the movement made only slow progress and by 1900 there were on an average only four branches to each bank. By 1917 the average had reached twenty and there was a strong feeling that steps should be taken to prevent the smaller provincial banks being absorbed by the larger institutions and becoming mere branches in a system controlled from Stockholm. As a result of this agitation a Bank Act was passed in 1918 prohibiting the opening of branches without the permission of the Ministry of Finance. In the following year another Bank Act was passed which made bank amalgamations de-

pendent on the sanction of the Ministry of Finance, which was to be granted only if the amalgamations did not appear to be contrary to public interest.

The development of Sweden's banking system is illustrated in the following table[1] :—

	1901–5	1906–10	1911–15	1916–20	1921–25
New banks formed	19	26	5	16	5
Existing banks taken over by new banks	5	4	1	2	4
Banks amalgamating with other banks	6	14	17	37	10
Banks otherwise ceasing business	..	2	1	2	..
Banks in operation at end of period	74	80	66	41	32
Number of offices	400	625	721	1410	1091

Since 1925 several mergers have been sanctioned and the number of banks has been reduced to 28. Three of these, Stockholms Enskilda Bank, Skandinaviska Kreditaktiebolaget and Svenska Handelsbanken, account for over one-half of the total deposits of the whole system. It is difficult to resist the conclusion that in Sweden, as in England, public opinion became concerned at the consolidation movement only when its chief work had already been accomplished, and that since 1918 the tangible advantages of the smaller and weaker units being absorbed by the larger institutions have induced the authorities to use their powers to guide rather than to obstruct the amalgamation movement.

It is perhaps interesting to point out the parallel trend of public opinion in England. The technique employed in giving effect to it was, however, quite different. In Sweden the Riksdag passed special legislation empowering the Ministry of Finance to control amalgamations. In England the government stated that further amalgamations would not be looked on with

[1] *Uppgifter om Bankerna*, 1935.

favour and the banks agreed to obtain the consent of the authorities before undertaking further mergers.

Capital and surplus

There are various provisions designed to ensure that capital shall be adequate: provisions for a minimum capital, so that new institutions shall not be set up easily without adequate financial backing: provisions for the maintenance of a ratio of capital to liabilities, to secure for depositors a reasonable margin of safety.

The minimum capital is normally 1 million kronor, but if it can be shown that the bank will operate locally on a restricted basis the capital may be less, subject to an absolute minimum of half a million kronor. At the present time no bank has a capital of less than 1 million kronor, and the average is over 17 million kronor. The shareholders must be Swedish subjects and must number not less than twenty. No business may be carried on before registration, which is not granted unless 20 per cent. at least of the capital has been subscribed and paid, and guarantees satisfactory to the Inspector of Banks have been obtained for the balance.

Until the reserve amounts to one-half of the share capital, 15 per cent. of the annual profits have to be placed to reserve. Premiums received on the issue of shares have to be placed to reserve, as must any amount paid up on shares forfeited. Reserves may only be drawn upon to cover losses which cannot be met out of special reserves. Apart from a reduction of capital, no payment may be made to shareholders except out of profits and then only to the extent that they are not required for reserves.

Up to 1928 the capital of a bank could not be reduced as long as it continued to carry on business. In that year, however, a Bank Act was passed permitting a reduction of capital under certain stringent conditions. As the law stands at present the directors must call a general meeting, if more than 10 per cent. of the bank's capital

is lost. If, at or before this meeting, the shareholders have subscribed sums sufficient to raise the capital to the amount required, the bank may continue in business provided that the amount subscribed is paid in cash immediately, or guarantees for such payments have been given to the satisfaction of the Inspector. If the new capital is not subscribed, or is not paid up within three months from the date of the general meeting, the bank must liquidate.

The Bank Act of 1911 limited the amount of deposits which a bank might accept to five times its " own funds ". This stipulation led to a number of amalgamations of banks having a relatively large capital with those having relatively large deposits.

The Bank Act of 1920 amended this arrangement, but deposit liabilities are still related to the size of the bank's "own funds", which, as defined in the act, comprise capital, reserves and undistributed profits, together with *förlagsbevis.* These latter are special interest-bearing bonds, the holders of which rank after ordinary creditors. They were issued by several banks during the crisis of 1920–22, in order to strengthen the banks' cash position. Further issues were necessitated by the Kreuger breakdown in 1932 and the amount outstanding reached 258 million kronor at the end of that year, although by the end of May, 1937, it had been reduced to 98 million kronor. In many respects these bonds fulfilled the same function as did the issue of preferred stock to the Reconstruction Finance Corporation in the United States of America. They do not, however, carry voting rights.

The ratio between a bank's own funds on the one hand and its deposit liabilities on the other is calculated as follows. A bank whose own funds are under 5 million kronor may not accept deposits to an extent greater than five times its own funds, plus an amount equal to its credit balances with other banks in Sweden. Thus a bank with capital and reserves of 4 million kronor would be allowed to accept deposits up to 20 million kronor. If, however, the bank redeposited 2 million kronor with other

banks it could accept additional deposits of a like amount making 22 million kronor in all. If a bank's own funds are above 5 million kronor deposits are limited to 25 million kronor, plus nine times the difference between the total of the bank's own funds and 5 million kronor. In no event, however, may total deposits be greater than eight times the bank's own funds. Thus a bank with capital and reserves amounting to 10 million kronor could accept deposits up to 70 million kronor. Where capital and reserves amount to 20 million kronor or over deposits are limited to eight times the amount of capital and reserves.

The general effect of these somewhat complicated requirements is to fix the proportion between own funds and deposits at a figure ranging between 1 : 5 in the case of the smaller banks, and 1 : 8 in the case of the larger banks, the principle presumably being that the smaller institutions require a greater margin of safety because their risks cannot be so widely spread. This leaves unexplained the provision, limited to banks whose capital and reserves are under 5 million kronor, that deposits with other banks increase *pro tanto* their capacity to accept deposits. The aim of the authorities is apparently that of encouraging the smaller institutions to redeposit.

Apart from theoretical considerations the provision is not of vast practical importance, as with the progress of the consolidation movement the number of banks with capital and reserves of under 5 million kronor has been reduced to 10 and their total liabilities on current, deposit and savings account amount to only 2¼ per cent. of the total for the whole banking system.

It should perhaps be added that the Crown was empowered by a Bank Act passed on 31st May, 1934, to grant certain exemptions from the above requirements. Banks whose own funds exceed 5 million kronor may be released from the requirements that total deposits may not exceed eight times the amount of own funds, provided that the amount of their excess deposits is covered by an equal amount of cash in hand and deposits with the Riksbank.

Assets

Even before the War the Swedish banks played an important part in long-term financing of industry, although they were prohibited from dealing in securities for their own account. The need for the provision of capital through the banking system was, however, recognised, and the Emission Banks Act was passed in 1909, under which investment banks could be formed to buy and sell securities, underwrite new issues and generally carry on the business of finance houses. No investment banks, however, were formed under the act, as the Bank Act of 1911 permitted banks to acquire and hold shares to a limited extent. Furthermore, the commercial banks could form subsidiary finance companies under the ordinary joint stock company law.

In the prosperous War years new capital issues became numerous, a process which the banks assisted by advancing freely against shares. Most leading banks secured a direct interest in the flotation of new companies and in the expansion of old companies by forming subsidiary finance companies, and many banks acquired in this way majority or important minority holdings in industrial enterprises. Such a policy not only impairs the liquidity of the banking system, but also renders credit regulation more difficult.

The policy of the banks was brought to public notice by the Banking Commission which, appointed in 1924 to examine the relations between banks and industry, reported in 1927 in favour of far-reaching alterations in bank law. By then, however, some measure of industrial recovery had been seen, and many of the frozen assets of the banks had been liquidated. The report was shelved.

In the period of recovery and prosperity up to 1929 loans on securities again increased, which weakened the banks when depression came, and caused serious difficulties when the suicide of Ivar Kreuger in March, 1932, precipitated a crisis. The collapse involved Skandinaviska Kreditaktiebolaget, which had to be assisted by

the government to the extent of 215 million kronor. The Riksbank announced publicly that stricter control of the banking system was desirable, and a new Banking Commission was appointed to re-examine the relations between industry and the banks. It was on the basis of the report of this Commission that the Bank Act of 1933 was framed. It came into force on 1st January, 1934.

As a result of this legislation the type of asset which a bank may acquire is strictly defined, the general intention being to make the ownership of shares by banks the exception rather than the rule. The act expressly prohibits banks from trading except in gold or national or foreign currency, bills of exchange, cheques, assignments and debts in general (except *förlagsbevis*, which give a right to payment only after other creditors have been satisfied). A bank is in general not entitled to acquire an asset in which it may not trade, although there are important exceptions to this rule.

A bank, for example, is allowed to acquire the premises necessary for the conduct of its own business, either directly, or indirectly by taking shares, bonds or *förlagsbevis* of a company formed for this purpose, the share capital of which amounts to at least one-third of the book value of the property.

A bank may also, with the approval of the Crown, buy the shares of another Swedish bank, a foreign bank or a Swedish company, where such acquisition is deemed advantageous, from the point of view either of the public or of banking in general. Bonds issued by such companies may also be acquired with the approval of the Crown.

In order to protect an advance or credit a bank may acquire, either at public auction or on the stock exchange, any asset, except its own shares, on the security of which it has granted a loan, if it appears that unless it does so it will incur considerable losses. If the asset so acquired consists of real estate, mines, factories or ships, the bank

may take instead the shares, bonds or *förlagsbevis* of a company formed to manage the property or carry on the business in question. In the event of a company so formed selling its assets to another in exchange for shares, the bank may accept shares of the second company. Any asset acquired in the manner outlined above must be liquidated at the earliest favourable opportunity—at latest when it can be liquidated without loss to the bank.

It might have been expected that these restrictions would have resulted in a decline in the amount of shares held by the banks, but up to 1935 the movement was in the opposite direction. This is explained by the necessity of the banks taking over securities against which loans had been granted. The trend is illustrated by the following table :—

	(In Millions of Kronor)					
31st December :	1931	1932	1933	1934	1935	1936
Shares held . .	108	129	182	341	355	299
Loans against shares .	1183	888	707	597	546	580

The figures for 1936 suggest that the banks are using the opportunity presented by the rising trend of values on the stock exchange to reduce their holdings of shares, but that part of the public's purchases is being financed by the banks.

It was feared that the restrictions on the ownership of shares by banks contained in the Bank Act of 1933 would deprive the smaller industrial companies of their customary method of obtaining long-term capital. A semi-official banking institution for industrial credit (A/B Industrikredit) was therefore formed in the autumn of 1934. Its object was to relieve the banks of certain assets which they were no longer entitled to hold and generally to provide long- and medium-term funds for industry. Its total share capital was 8 million kronor,

of which 6 millions was provided by the state and 2 millions by five of the larger banks.

The Bank Acts make some attempt to reduce unsecured advances to a minimum by establishing a rule that no credit may be granted unless satisfactory security has been offered. To this rule there are, however, important exceptions. Unsecured advances may be granted to the state, to municipalities or other public bodies whose constitution is approved by the Crown, and to banks and banking institutions at home or abroad. The rule is also relaxed in favour of traders taking short-term advances for trading purposes—" if it is believed that the loan will be repaid ", and bills of exchange payable in another district may be discounted, even if unaccepted, if the drawer is solvent.

Finally, the Bank Act of 1933 endeavours to tighten up the conditions on which loans are made on shares—an aim that is complementary to the restrictions on ownership of shares contained in the same measure. It is expressly laid down that there must be a reasonable margin between the amount of the advance and the market value of the securities, the margin depending on the nature of the shares, and that if possible the amount of the advance should never exceed the market value of the shares. A bank's own shares are not eligible as collateral, neither are *förlagsbevis* or shares in enskilda companies—because of the unlimited liability—nor bonds and shares of companies whose principal business is that of dealing in or issuing securities.

Contrary to the law existing in other countries, no limit is set to the amount of credit granted to a single customer, the legislature contenting itself with the general admonition that special care must be taken that loans to any one customer are not so great that the stability of the bank is endangered. It is perhaps a little curious that, with the example of the Kreuger failure fresh in their minds, the sponsors of the Bank Act of 1933 did not fix a more precise limit.

Reserve ratios

Besides prescribing a minimum ratio of capital to liabilities, the Bank Acts fix the minimum reserves which a bank must maintain against its demand liabilities. It must be noted that no provision is made for a minimum reserve against time and savings deposits, which account for about 80 per cent. of total deposits. Against its demand liabilities, however, a bank must maintain reserves in the form of readily realisable assets which, with the addition of till money, amount to 25 per cent. of demand liabilities. If the reserve falls below this level it must be replenished as soon as possible. Readily realisable assets are not defined by the act, but it is the practice to include cash in hand, balances with the Riksbank and with other banks, both Swedish and foreign, sight drafts and bonds quoted on Swedish and foreign stock exchanges. Owing in part to the easy money conditions at present prevailing in Sweden, the aggregate cash balances of the commercial banks with the central institution alone amount to over 25 per cent. of the demand liabilities of the whole system, and this is also true of most of the banks individually.

In addition to the reserve requirements mentioned above, there is a curious provision relating liquid reserves to the book value of the bank's real property and its capital and reserves. If the bank owns real estate for the purpose of providing bank premises it is bound to include in the assets forming its reserves cash equal to the excess of the book value of the property over 10 per cent. of its own funds. Provision is made for property acquired before the passing of the act of 1911, in that a value lower than the book value of the property may be fixed by the Crown, at the request of the board of the bank. The intention is presumably to discourage unreasonable expenditure on premises, although in practice bank premises are almost always carried at a very low figure.

Before we leave the subject of deposits, two provisions may be mentioned. The first lays down that no one depositor may have a balance on savings account in excess of 4000 kronor. According to law withdrawals from savings accounts are subject to seven days' notice, but in practice amounts up to 1000 kronor are paid on demand. Thus small depositors use savings accounts as current accounts and the restriction is designed to limit this practice. The second provides that a bank may not make the granting of a credit conditional on the amount of the credit—or a part thereof—being placed on fixed deposit for a period exceeding six months.

Management

The Bank Act sets out the powers and duties of directors and the manner of their appointment. It is not proposed to examine these provisions in detail, but one or two points are perhaps worth noting.

The conduct of a bank's business is in the hands of its board of directors. The board is selected by the shareholders from their own number and must consist of not less than five nor more than twelve members, although in special circumstances, with the consent of the Crown, the number may be increased to a maximum of fifteen. One member out of five may be an official of the bank. Directors must be resident in Sweden. They serve for a period of up to five years, but may be removed before the expiry of their term of office by a general meeting.

The Bank Act of 1933 made some attempt to regulate the internal organisation of the banks, as it had been found that boards of directors had tended to leave major decisions of policy to officials who, however competent, had not the same legal responsibility for the prudent conduct of the bank's business. The board is specifically precluded from leaving to the decision of an official of the bank a matter which by its nature is one which concerns the board, unless detailed instructions—which have a maximum validity of one year—are given relating

to the various aspects of the matter in question. These detailed instructions have to be filed with the Bank Inspectorate. The board is expressly forbidden to delegate the power of making decisions on the following subjects :—

(1) the opening or closing of a branch or the acquisition of the business of another bank ;
(2) the purchase, reconstruction or sale of bank premises ;
(3) the granting of a credit—
    (a) to a member of the board of the bank or of the local board at one of its branches ;
    (b) to a company or association of which such a person is an official or in which he has an important interest as shareholder or member ;
    (c) to a company, a director of which is an official to whom is delegated the power of taking a decision on behalf of the board of the bank, or an auditor of the bank. The board may, however, state the limits within which advances may be made to such persons, companies or associations without a special resolution of the board ;
(4) the purchase of bonds or shares, except where they are taken over to protect a credit ;
(5) the fixing of the usual rate of interest allowed on deposits or charged on advances, except in conformity with a general change in interest rates ;
(6) the engagement or discharge of higher officials.

Members of the board who by infringing the law, whether by design or accident, occasion loss to the bank are jointly and severally liable for the loss—an endeavour to create a sense of personal responsibility by statute. Another provision prohibits any director or official of a bank to whom is delegated the power of making decisions on behalf of the board from being at the same time a director of a finance or issuing house.

Loans may not be made to directors, managers, officials

or to companies in which such persons have a substantial interest unless they are secured by trustee securities. Bills of exchange drawn by such companies may, however, be discounted, if they are based on genuine commercial operations.

Audit

The annual accounts of a bank must be examined by at least three auditors, of whom at least two are chosen annually by the shareholders in general meeting and one is appointed by the Inspectorate. All the auditors must be persons of business experience and one of those chosen by the shareholders must have had audit experience. Persons nominated may not occupy the position of director or official of the bank, or hold a subordinate or dependent position in relation to a member of the board.

At least once every half-year the auditors must undertake an audit which includes an examination of the minutes of the directors' meetings and of the instructions issued by the board concerning the granting of advances, a verification of the more important loans and credits granted and investments made, an investigation into the measures adopted in dealing with assets taken over to protect the loans which they were intended to secure, and a perusal of any observations which the Inspectorate may have addressed to the board or to any of the directors. The directors must make available to the auditors any information they require. If necessary, the auditors may request the board of directors to convene an extraordinary general meeting, and if the request is not complied with, the meeting may be called by the Inspectorate.

Detailed regulations are laid down governing the valuation of assets in the balance sheet, the general principle being that the assets should not show in the balance sheet at a figure higher than their market value or cost, whichever is lower. Assets apart from real property which the bank uses for its own purposes may, however, be shown above cost, if special mention is made

of the fact in the annual report. Doubtful debts must be entered at their estimated value and bad debts written off entirely. Capital and reserves must be shown separately, and preliminary expenses may not be included as an asset.

Inspectorate

In the early days control was exercised directly by the Ministry of Finance. Thus the legislation of 1846 which dealt with note-issuing banks made compulsory the regular filing of reports which, since 1871, have included both monthly returns and annual statements containing profit-and-loss account and balance sheet. These were at first examined by a bank inspector who was an official of the Ministry of Finance. By 1907, however, the working of the Bank Act of 1903 had demonstrated the need for a specialised organisation and a Bank Inspectorate was appointed by the Crown under the control of, and responsible to, the Ministry of Finance.

Members or officials of the Inspectorate may not be members of the board of a bank or employees of a bank. The duties of the Inspectorate include those of seeing that the banks conform to the law and generally of watching their activities with a view to safeguarding the interests of depositors. In addition to the powers of examining the books and obtaining any information deemed necessary, the Bank Inspectorate may call meetings of the board, and in a few instances the board of a bank has actually been convened under this section. If the board fails to convene an extraordinary general meeting when requested to do so by the Inspectorate, the Inspectorate may call such a meeting itself and be represented at it.

Immediately after the end of each month a balance sheet in the prescribed form must be delivered to the Inspectorate, together with a statement showing the rate of interest on deposits and advances and the rate of discount applied during the month. This information is published in the monthly report of the Inspectorate. It

is interesting to note that the Inspectorate has no power of prescribing minimum or maximum rates.

The banks contribute annually towards the expenses of the Inspectorate on the basis of their own funds at the end of the preceding financial year. The rate of contribution is fixed by the Crown, but it must not exceed one-fifth per mille. In addition, the auditor appointed by the Inspectorate has to be paid by the bank concerned.

Swedish Banks' Association

The common aims and interests of the enskilda banks and the similarity of their legal structure were responsible for the formation of an Enskilda Banks' Association in 1880. When the enskilda banks lost the right to issue notes, the joint stock banks were invited to take part. Finally, in 1910 the old Association was dissolved and the present Swedish Banks' Association formed.

The members undertake to adopt the scale of rates and fees fixed by the Association, the scale including collection charges, commissions for accepting drafts, issuing guarantees, opening letters of credit and holding securities in safe custody. They have also undertaken not to sell foreign exchange quoted by the Riksbank to the public at a rate below the Riksbank's selling rate. The existence of the Association has greatly aided the central bank in its task of credit control.

Central-bank control

Control by a central institution is none the less real when it takes the indefinite form of moral suasion, and the Riksbank exerts a considerable influence over Swedish commercial banks in this way. An example is seen in the foreign exchange control imposed by the Riksbank soon after Sweden's abandonment of the gold standard in September, 1931. When on 21st November, 1931, the Riksbank was forced to give up the idea of pegging the krona to sterling at a definite rate, the Swedish Banks'

Association agreed to restrict credits for imports or for speculation in foreign exchange or commodities. For a short period the Riksbank attempted to examine every demand for foreign exchange, but the attempt was soon given up and the banks agreed merely to restrict credit in general. This agreement remained in force until August, 1932, although it was largely inoperative from about February, 1932.[1]

Control of short-term money rates by means of changes in the Riksbank's rediscount rate is normally effective, since there is a convention, usually observed, that the commercial banks adjust their three months' rate to changes in the Riksbank's rediscount rate. The response of long-term interest rates to central-bank action is less immediate.

It should be noted that a relatively large proportion of the deposits of the country is in the form of time and savings accounts. Deposits on savings account with the commercial banks amount to about 682 million kronor, fixed deposits to 2259 million kronor, while current accounts and short-term deposits amount to only 892 million kronor, i.e. 23 per cent. of the total.[2] In addition, the deposits of the savings banks, excluding the Post Office Savings Bank, amount to 3200 million kronor, an amount not far short of the combined deposits of the commercial banks. There is no convention regarding the relationship between the Riksbank's rediscount rate and the rates applied by savings banks, which means that the commercial banks' rates on savings accounts are also unaffected by reductions in the Riksbank's rate, since they would not be in a position to lower their savings account rate without the assurance that the savings banks would do the same.

The situation is well illustrated by the events of 1932 and 1933. On 1st September, 1932, the Riksbank reduced

[1] R. A. Lester, *Sweden's Experience with Managed Money*. Svenska Handelsbanken, January, 1937.

[2] At 31st December, 1936.

its rate from 4 to 3½ per cent., but no change was made in the rates of the commercial banks, and the immediate effect seems to have been to encourage rediscounting, which increased in November and December of that year. At the turn of the year, however, the Post Office Savings Bank and the larger savings banks reduced their deposit rates, whereupon the commercial banks followed suit by reducing both deposit and loan rates by ½ per cent. In pursuit of a cheap money policy the Riksbank was desirous of lowering its rate still further, but only felt itself strong enough to do so on 1st June, 1933, when the savings banks, after prolonged negotiations, also agreed to reduce their rates. Even then, however, the only action taken immediately by the commercial banks was to lower their discount rates, leaving the other rates unchanged until 1st September, 1933. On the other hand, when in December, 1933, the Riksbank reduced its rate to 2½ per cent., the savings banks adjusted their rates as well, as did most of the commercial banks. In a country such as Sweden, where savings accounts play such a large part in the financial system, it would seem desirable that close co-operation should be maintained between savings banks and commercial banks on the one hand and the central institution on the other.

The events described above show the difficulties of making an easy money policy immediately effective, owing to the slowness of the response of the banks to changes in the discount rate. Money rates have, however, now fallen to a very low level, and increasing industrial activity and rising prices have caused attention to be given to the possibility of having to check any further expansion.

It has been suggested that the powers of the Riksbank are insufficient for this purpose and to some extent this is true. Rediscounting at the Riksbank has almost disappeared since 1933, which makes market rates much less responsive to central-bank action than they would be if the banks were habitually resorting to the central institu-

tion. It is interesting, however, to note that banking experts who gave evidence at the public inquiry in 1932 into the proposed amendments to the Bank Act of 1911 advocated that banks should refrain from rediscounting at the Riksbank, except to satisfy seasonal demands or those of an exceptional character.

The scope for open-market operations as a means of raising long-term interest rates is also limited, for the Riksbank's holding of government securities is small, amounting to only 2 million kronor. To overcome this difficulty, arrangements have been made with the National Debt Office whereby government securities will be created and sold in the market as and when required.

The Riksbank is empowered to allow interest on money deposited with it, but to what extent this could be used effectively to attract deposits from the customers of the commercial banks, thus reducing the cash base of the commercial banks, is difficult to say. It has never had a trial on a large scale.

To strengthen its control, the Riksbank has prepared a bill which, if passed, would enable the Crown to issue instructions regarding the reserves of the banks. It has already been noticed (p. 341) that under existing law banks must maintain a reserve of readily realisable assets amounting to at least 25 per cent. of their demand liabilities. It is now proposed to extend the scope of this provision so as to include deposits at not more than one month's notice—except savings deposits—and to require that of the 25 per cent. reserve, three-quarters should be in the form of deposits with the Riksbank. These requirements might be applied to all banks or to banks above a certain size.

These proposals indicate that the problem of credit control in Sweden is far from being solved, but that energetic steps are being taken to invest the authorities with the powers necessary for the successful pursuit of a deliberate monetary policy.

Conclusion

The Swedish Government has from earliest times exercised some control over the formation of banking institutions. Commencing at a time when banking and administrative technique were still undeveloped, the early manifestations of control were confined to such elementary principles as registration and publicity. The growing importance of banking necessitated a corresponding increase in statutory control, and in the second half of the nineteenth century a number of measures was passed. A comprehensive law was enacted in 1911, giving Sweden the distinction of having the first comprehensive banking code on the continent of Europe, and although it has been amended from time to time, it still forms the basis for the present system of control.

The Bank Act of 1911 forms a rigid code. Detailed provisions are laid down in the law itself instead of being contained in executive orders of a government department, as is so frequently the case with modern banking legislation. The instances in which the controlling authority—the Inspectorate—is required to exercise discretionary powers are, in general, few and unimportant, and in such circumstances control by a state official has worked well.

In the field of credit control the Riksbank is able, in normal times, to exercise adequate control, but the extreme liquidity of the banking system in recent years has caused doubts to arise as to the ability of the central institution to check an inflationary movement. The proposals now being discussed should, if put into operation, provide the authorities with all the powers required for the pursuit of a deliberate monetary policy.

SWITZERLAND

SWITZERLAND

The Swiss banking system

ALTHOUGH the Swiss banks are not, comparatively speaking, specialised, they are generally held to fall into six distinct groups. First there are the large commercial banks, which date from the middle of the last century, have branches all over the country and, as a result of amalgamation, are now only seven in number. These banks, which to-day control a smaller proportion of total banking resources than formerly,[1] are primarily deposit banks, but also have some of the characteristics of the German *Grossbanken*, in that they are interested in the long-term finance of industry, though seldom taking control or being as intimately connected with it as the German banks, and acquire funds by the issue of debentures (*obligations de caisse* or *bons de caisse*) normally of up to five years' maturity. They also take an active part in the issue, flotation and underwriting of securities, and buy and sell securities—though only to a limited extent—for their own account. In Zürich and Basle, as in most continental centres, the big commercial banks are themselves members of the stock exchange, but transactions on behalf of their customers greatly exceed those for their own account. Until recently, another important part of their work was the financing of foreign business and the granting of loans abroad.

The second group is that of the 24 cantonal banks,

[1] Demand, time and savings deposits and debentures of the big banks amounted to 5915 million francs in December, 1931, and to 3156 million francs in March, 1937. The savings deposits and debentures of cantonal banks rose from 5545 to 5834 million francs.

2 A

whose total resources now greatly exceed those of the 7 big banks. They may be compared with the American state banks, for they are subject to the various cantonal laws, but, unlike the American banks, nearly all of them are state-owned. Their activities are as diverse as the laws which govern them, some being concerned mainly with ordinary commercial banking, others with loans on mortgages, others with the financing of industry. The granting of mortgage loans is a particularly important part of their business. Like the big banks, they rely for funds largely on the issue of short-term debentures. Many of the cantonal banks have branches.

Thirdly, there are some 180 local banks, confined to local enterprises, and thus having more limited functions than the other two types of commercial bank. Here, again, mortgage loans play an important part.

The three other groups of banks are savings banks, trust companies and Raiffeisen banks, and do not concern us here. There are still some private banks in Switzerland, but the joint stock and cantonal banks have made big inroads on their commercial banking business, which is now comparatively unimportant.

The origin of the Banking Law

There was no general commercial banking law in Switzerland prior to the end of 1934, though all banks were, as joint stock companies, co-operative societies or private partnerships, subjected to the same requirements as similarly constituted institutions in other departments of economic life. The savings banks have their own regulations, especially in regard to the employment of their funds, and the 24 cantonal banks are also legally controlled by the local governments of the cantons in which they are situated.

The idea of introducing a measure of control of commercial banks is not, however, new in Switzerland. Proposals for legislation were considered before 1914, but had to be postponed when the Great War broke out,

and do not appear to have been taken up again seriously when the War was over.

As in most other countries in which banking legislation has been introduced in recent years, the Banking Law in Switzerland had its immediate origin very largely in difficulties arising from the depression. A thriving industrial and commercial community in the heart of Europe, seldom involved in the wars which have ravaged their neighbours, the Swiss have for decades been financially interested in and indeed dependent on international trade. The Swiss banks have, even in normal times, been substantial depositaries of foreign funds, for Switzerland has three important money centres ; but in the constantly recurring times of crisis which have threatened one European currency after another since the War, the flow of money to Switzerland has been on an especially large scale. With the onset of the world depression in Central Europe in 1930–31 the big commercial banks in Switzerland found themselves flooded with foreign capital seeking refuge, much as the British banks did, to their ultimate disadvantage, up to 1931. Like some of the British banks, too, they lent a large part of these funds to foreign borrowers, mainly in Germany and South-east Europe.

It was the freezing of these loans that led largely to the difficulties of the banks. Unlike the British banks, however, the Swiss banks were unable to carry the position and wait for better times, and found it necessary to liquidate their frozen assets at great loss.[1] Many of their investments in Switzerland, too, became immobilised, and the banks in general suffered big withdrawals ; while the large commercial banks were hit chiefly by withdrawals by foreign depositors, the local banks suffered mainly at the hands of Swiss depositors, as a result of lack of confidence and of a reduction in the rates of interest paid on deposits. The position was, of course, aggravated by the stranglehold which deflation

[1] Public opinion against foreign commitments was also a factor in this liquidation.

imposed on the economic life of the country up to September, 1936. Another difficulty of the Swiss banks was that they obtain a large proportion of their funds by the issue of short-term bonds, and these seemed to be continually maturing at inappropriate moments. The reduction in the balance-sheet totals which characterised the accounts of the Swiss banks in 1934 and 1935 was due largely to the unwillingness of the public to convert maturing bonds into new bonds. The Swiss *rentier* was not attracted to renewing his 4 per cent. bank bonds when he could purchase in the market government or cantonal bonds yielding 5 per cent. Apart from the difficulty of finding cash to redeem them, however, the banks did not suffer unduly from this, for profitable openings for the employment of funds were few. The balance-sheet totals of the seven big banks were reduced in the four years 1932 to 1935 inclusive from 7·2 milliards to 4·1 milliards of francs. The repayment of 3 milliards of francs in this way is a remarkable proof of the fundamental strength of the banks as a whole.

In 1931 the Banque de Genève, a big local bank, failed. In 1932 the Comptoir d'Escompte Suisse suffered a large withdrawal of deposits, but was saved by the intervention of other banks and of the federal government, and was reconstructed in 1933. During 1933 one or two other banks were forced to reduce their capital, and the Banque Populaire Suisse, with a large proportion of its advances frozen, was only saved by the intervention of the state, which provided it with 100 millions of francs of new capital. It has more recently been reorganised a second time. Other smaller banks also had to issue new capital, in order to increase liquidity in the face of withdrawals for hoarding and of transfers of funds to the cantonal banks, which enjoy cantonal guarantees. One feature of the Banking Law of 1934, which we shall not consider in the following pages but which is important in the present connection, is that which enabled banks to claim a moratorium if they could show that, in spite of their

difficulties, they were fundamentally solvent. A number of banks, big and small, took advantage of this.

Although losses suffered by depositors were ultimately small, yet, in view of the failures alluded to above, a commission of experts was set up in 1933 to draft proposals for a banking law. They reported in 1934 and their report forms the basis of the law of that year. The law in its draft form excited appreciable opposition on the part both of bankers, who felt, and still feel, that it was dictated by political considerations, and of other perhaps less biased critics, who held that, even if such control as the law proposed had been in force, it could not have prevented losses attributable to unforeseen currency developments abroad and to the freezing of assets.

The Swiss legislators realised that banks cannot be made safe by act of parliament. Their main aim, in view of the importance of banking in the modern community and especially in the Swiss economy, was to narrow as far as possible the scope for unsound practices and to extend to all commercial banks the measure of control to which the majority of banks had already subjected themselves voluntarily. A feature of Swiss banking which is in some ways unique, but may be compared with the American system of clearing-house associations, is the existence of a number of independent auditing associations (*sociétés fiduciaires*), which make regular examinations of the accounts of the banks which group to create them. It will be seen that this movement has been legally extended and the functions of such bodies legally defined.

The safety of the banks is important to Switzerland, not only for the ordinary reasons, but also because some proportion of their profits constitutes a valuable invisible export, and because the banks contribute substantially, as taxpayers, to the national exchequer. While, however, banking legislation was held to be essential, the lack of specialisation and the great diversity of banking business, in addition to the great variations in

the size of Swiss banks, made the task especially difficult. The law, it was claimed, should therefore confine itself to general principles, to which exceptions would be admitted.[1] But the reader will see that it contains an appreciable amount of detail.

The control of banking activity, so the Swiss philosophy runs, has three essential objectives: to protect depositors; to provide the national economy with sufficient credit, and agriculture, industry and commerce individually with their appropriate shares of that credit; and to furnish the National Bank with information for the more enlightened pursuit of its monetary policy.[2] Let us now see how these aims have been carried out.

Scope of the law and management

The Banking Law of 1934 [3] applies to banks (including cantonal banks), private bankers,[4] savings banks and any financial companies of a banking character which appeal to the public for funds, unless in any provision any one class is expressly excluded. Only the above institutions, too, may call themselves banks. There was some opposition to extending the law to cantonal banks, which conduct business under the complete guarantee of their respective cantons, and which offered to submit voluntarily to the chief provisions of the law. "Financial companies of a banking character" also felt that they should not be included, for the sole banking characteristic of very many of them is that they have in the past issued debentures.[5]

[1] Message of the Federal Council to the Federal Assembly, February, 1934, p. 3.

[2] *Ibid.* p. 5.

[3] The law of November, 1934, is of a general nature. It is supplemented and given detail and precision by an executive order of the Federal Council dated 26th February, 1935. The law and the order must be read together, and the "law" in this chapter is understood to comprehend them both. They came into effect on 1st March, 1935.

[4] About 80 in number.

[5] Under a decision of the Federal Supreme Court in 1936, this is sufficient to make a financial company a bank for the purposes of the law.

The supervisory authority is a newly created federal Banking Commission of five, all of whom are required by law to be technical banking or auditing experts, but to have severed their banking interests. The Commission's function is to see that the law is carried out; its expenses are borne by the government, and it presents an annual report to the Federal Council. (The Swiss Federal Council, it will be remembered, while not exactly a cabinet, is the executive organ of government.) The articles of association of all new banks have to be submitted to the Commission, with the exception of cantonal banks, and other banks whose liabilities are guaranteed by a canton. All banks except cantonal banks have to provide themselves with articles of association clearly stating their character, mentioning expressly the operations in which they are to engage and their place or places of business. The law also requires that every bank shall have a clearly distinguished management and board of directors, each of the two departments to have its own responsibilities. In particular, the chairman of the board may not take part in the management of the bank, though exceptions may be made with the permission of the Banking Commission, it being recognised that no detailed rules could be laid down.

Responsibility

This is a section of the law which does not apply to cantonal banks, for the cantonal laws have their own provisions in this respect; nor to private bankers, who are subject to the ordinary commercial law. It applies, however, to all other banks. As in English company law, any individual who signs or is responsible for a share prospectus is individually responsible to and suable by any party who suffers loss through his negligence or ill-intent. Responsibility does not, however, stop here in Switzerland, for the act extends the principle to persons concerned with the direction, management and control of a bank, and makes them individually responsible to each

shareholder and creditor of the bank for damage or loss caused by any intentional or negligent falling-off in their duties. This seems at first a drastic innovation, for it would appear to apply to the transaction of day-to-day business, but the act goes on to say that where, as is usually the case, the damage is suffered by the bank itself, and its creditors suffer only an indirect or secondary loss, any claim by a creditor or shareholder can only be made in lieu of that of the bank. Further, no action can be taken by a creditor unless the bank is in liquidation. Such a restricted right has a very limited value.

The rest of this section is concerned with rights in liquidation and with penalties for infraction of the Banking Law. It will be noticed that there is nothing similar to the provisions ruling elsewhere that directors should have a personal share interest in the bank, or that they should be removable by the supervisory authority.

Capital

Capital requirements are as follows :—

In cantonal banks capital must amount to 5 per cent. of liabilities ; in co-operative banks with unlimited liability, to 5 per cent. of liabilities ; in other banks, to 5 per cent. of such liabilities as the bank invests in given types of security (e.g. federal, federal railway, cantonal and communal bonds, and bonds guaranteed by these bodies), and 10 per cent. of other liabilities.

Capital is carefully defined by the law. It includes :—

(a) all paid-up capital ;
(b) 50 per cent. of unpaid capital, in respect of which guarantees have been lodged ;
(c) any amount guaranteed unconditionally by a commune, in a special instrument of guarantee ;
(d) any sum guaranteed free of all charge by the shareholders ;
(e) balance-sheet reserves (general reserves as opposed to reserves for special purposes) ; and

(f) any credit balance brought forward from the previous year. (Debit balances have to be deducted from capital for this purpose.)

A bank's liabilities are those appearing in its balance sheet. The Banking Commission has power to modify these requirements in special cases, with or without conditions.

Reduction of capital

The reduction of capital by the repayment of shares is permitted only—

(1) if the capital as thus reduced is sufficient to protect creditors, and liquidity is not impaired ;
(2) after two months' notice, during which such creditors as desire it are to be paid out or given security; and
(3) if, where shares are repurchased at less than their par value, the resulting book profit, after providing for the writing down of depreciated assets, is carried to reserve.

These provisions are normal and call for no comment.

Surplus

Banks have to set aside at least 5 per cent. of their annual net profits to reserve, until reserve equals 20 per cent. of capital, or, in the case of banks without paid-up capital, to 5 per cent. of the funds entrusted to them by third parties. This provision does not apply to cantonal banks, which have their own requirements to meet, or to private bankers who do not appeal to the public for funds. In the case of most banks it has not involved any departure from existing practice. In 1932, for example, reserves amounted on the average to over 30 per cent. of capital.

Liquidity

This is one of the most involved parts of the law. The act defines two types of asset. First there are

"disposable" assets, which include cash, balances due from the postal cheque service, gold and foreign currencies, and clearing accounts at the National Bank. The second group — "easily mobilisable" assets — includes bonds, treasury bonds and bills discountable at or eligible to be pledged with the National Bank; deposits at other banks maturing within a month; treasury bonds, first-class bank acceptances and similar paper carrying the signatures of foreign drawers or acceptors and maturing within three months; funds lent for carry-over operations on the Bourse, and secured advances maturing within a month; loans under documentary and seasonal credits with up to a month to run; coupons of similar due date; and overdrafts guaranteed by securities pledgeable with the National Bank. Where such assets represent the liabilities of foreigners, they can only be considered mobilisable if payable in Switzerland and in Swiss money, or if transfer is certain. Assets of the above character which are already pledged are not included.

The act next defines short-term liabilities, which include those payable at less than a month's notice, current accounts, cheques and short-term paper not yet presented for payment, savings accounts called for repayment and due within a month, 15 per cent. of all deposits not yet called for repayment, short-term debentures, drafts and acceptances payable within a month, and liabilities on carry-over operations.

Starting with these long and detailed definitions, the law goes on to lay down certain legal minimum ratios between disposable assets, easily mobilisable assets and short-term liabilities. The liquidity requirements increase as the proportion of short-term liabilities to total liabilities rises, the sum effect being much the same as that achieved by the two ratios (for demand and time deposits) in American federal reserve law.

As shown in the table, when short-term liabilities do not exceed 15 per cent. of total liabilities, disposable assets alone must amount to 2·5 per cent. of short-term

liabilities, and disposable and easily mobilisable assets together to 25 per cent. of short-term liabilities, and so on. Modifications in special cases are permitted on the direction of the Banking Commission. Banks are required to set out in their statutory balance sheets a statement of their assets and liabilities under each of the above-defined sub-headings. (The rules in this section do not apply to private bankers who do not appeal to the public for funds.)

	Per Cent.	Per Cent.	Per Cent.	Per Cent.
Short-term liabilities to total liabilities .	Under 15	15–20	20–25	Over 25
Disposable plus easily mobilisable assets to short-term liabilities	25	30	40	50
Disposable assets alone to short-term liabilities	2·5	3	4	5

It will be apparent that these requirements, in so far as they link cash and short-term liabilities, and take account of other liquid assets, are more logical than those in other countries which link cash and total liabilities. The only criticism one would offer is that they are perhaps too detailed. A slightly more austere but simpler rule-of-thumb might have been just as effective; scientific precision in such matters, especially when applied to a large number of banks of various sizes and types, is impossible. At the time of writing—July, 1937—Swiss banks and especially the large commercial banks are far more liquid than the law requires, though still not as liquid, on the average, as British banks.

Contracts of pledge

While assets are under discussion, reference may be made to contracts of pledge. A practice of Swiss banks to which there is no parallel in this country is the pledging with the National Bank of securities which they

themselves have received in pledge from their customers as loan collateral. Under the new law the customer's consent is required in a special instrument, and no bank may pledge securities for an amount greater than the loan which it has already made against them to its customer. The practice of repledging, however, is not very widespread or important.

Accounts and balance sheets

Every bank must draw up a profit-and-loss account and balance sheet annually, and banks whose balance sheets amount to more than 20 million francs, a balance sheet every six months; while those with a balance sheet total of 100 millions or more must present a quarterly balance sheet. All these accounts and balance sheets have to be published or made available to the public, except in the case of private bankers who do not obtain funds from the public, and they are all drawn up on a pattern prescribed by the Banking Law. According to this prescription assets are set out under 21 heads, liabilities under 17: they are in fact such as to give a very clear indication of a bank's condition, and in this sense may be contrasted with the published accounts of English banks under the Companies Act, 1929.

The annual balance sheet has further to be accompanied by the following information:—

(1) total of guarantees and indemnities;
(2) total of liabilities through the endorsement of rediscounted paper;
(3) a searching classification of securities and shares under the following headings (which again are elaborately subdivided):—
    Swiss bonds,
    Swiss mortgage bonds,
    Swiss shares,
    foreign bonds and foreign shares.

The model profit-and-loss account, in its turn, contains

7 credit and 9 debit entries, which are particularly interesting as showing on what assets a bank makes its profits (interest on loans, commissions, interest on bills and securities, interest on real estate, etc.), and what are its main items of expenditure (interest on borrowings, commissions, salaries, contributions to provident institutions, general office expenses, costs of issuing loans, taxes, losses and depreciation). It is here, even more than in the detailed balance sheet, that the clues to a bank's condition can be found. The profit-and-loss account contains also an appropriation account with six debit entries. These accounts, again, give much more information than an English bank's profit-and-loss account.

The annual accounts must be accompanied by a report on the bank's work.

Savings deposits

Savings deposits are accorded a special protection under Swiss banking law. Some of the cantonal laws have long safeguarded the savings deposits of cantonal banks. The federal law now gives savings deposits in all banks a prior claim on assets in case of failure, up to 5000 francs per depositor. The only exception is that of savings deposits which are already guaranteed by a canton. A similar provision is found in the Argentine banking law of 1935, under which savings deposits up to 5000 pesos are given preferential rights. The closest parallel, apart from this, is the United States deposit insurance scheme (see p. 451). The protection afforded by the first draft of the bill was for deposits of up to 3000 francs, and it was stated that even this would cover the great majority of savings deposits in their entirety.

Relations with the National Bank

All banks must send copies of their annual accounts to the National Bank, and banks with a balance-sheet total of 100 millions or over are required in addition to send a monthly balance sheet. Smaller banks and finance

companies can be asked for six-monthly balance sheets. Further, the National Bank can demand explanations, and any other information it requires with regard to balance sheets. The purpose, however, is solely to provide the National Bank with statistical information, and it has no power to correct or comment on the activities of commercial banks.

The most interesting provisions of this section of the act, however, are those which make it necessary for banks to report to the National Bank any projected operations of a pre-defined character. All banks, of whatever sort, are bound to inform the National Bank before concluding in an amount exceeding 10 million francs [1] any of the following operations (or participating in any such operations) :—

(a) the granting of foreign loans for the provision of new funds or the conversion or consolidation of old debts, whether the securities are to be held in portfolio, publicly issued or distributed on commission ;
(b) the purchase or issue of shares of foreign companies, although rights to subscribe to new shares may be exercised ;
(c) the granting of credits and the making of investments abroad for periods of 12 months or over, or for less if the agreement permits the loan to be extended for a period of 12 months or over in all.

The National Bank may veto such operations or impose conditions, if considerations of the exchanges, of the rate of interest, or of the country's economic interests justify it. The National Bank is not concerned with the security offered for such loans.

A bank with a balance-sheet total of over 20 millions must inform the National Bank two weeks in advance of any intention to raise the rates of interest on its short-term debentures. The National Bank has no right of veto, but

[1] And, if market conditions justify it, smaller operations are to be reported.

if the general economic situation, the effect of the rate on the money market or the condition of the bank in question make it desirable, may attempt to dissuade the bank. The same applies to any reduction in the nominal value of such obligations and to bonuses granted on repayment.

Both of these provisions are born of experience. What is in brief the power to place an embargo on big foreign transactions is perhaps justified by the present international situation, but it was undoubtedly the losses sustained by the Swiss banks in Germany since 1931 that inspired this section of the law. Switzerland, it will be remembered, is still, though to a much less important extent, a creditor under the Standstill Agreements.[1] The second provision has its origin partly in the destructive competition of certain Swiss banks to attract liquid resources during the crisis, by raising unduly the rates of interest on their short-term debentures ; partly in the influence of agricultural interests which wished to restrain increases of rates on mortgage loans. As has been seen, this provision is not without parallel in the laws of other countries.

The extent of the National Bank's legal control is thus limited, though it touches important points in the country's economic structure. We must now consider the main organs through which other and more general measures of control are exercised.

Control and examination

Mention has already been made of the *sociétés fiduciaires* which have long been a feature of Swiss banking.

All banks must by law submit their annual balance sheets to an independent examining body, with the exception that cantonal banks are exempted if they possess a properly qualified examining staff approved by the Banking Commission.

The examiners' task is to see that balance sheets are drawn up in the form required by the law and to audit

[1] 440 million francs at the end of 1936.

the accounts. Banks which have their own inspectors are required to make their inspectors' reports available, with the aim of avoiding a double control, where possible.

Only properly recognised bodies may conduct these examinations, and they must follow the lines laid down by the Banking Commission. Their general business is limited to this and to matters connected with liquidations and financial reorganisations. They may not undertake banking or trustee business, and the Banking Commission may limit their fields of activity. The following can be recognised as examining bodies :—

(1) associations (*syndicats de revision*) examining the accounts of at least 12 banks and possessing a committee on which not more than a quarter of the affiliated banks may be represented ;
(2) joint stock companies or co-operative societies with a paid-up or guaranteed capital amounting to at least 100,000 francs ;
(3) limited partnerships or joint stock companies with at least 4 shareholders with unlimited liability, the companies to pledge at least 100,000 francs in cash or in securities, or more should the Commission require it.

Examining institutions have to show that they have an organisation suiting them to their work, and that their managers and examiners are of good reputation and have sufficient technical knowledge. No examining body may set a bank director or senior officer to examine his own bank. There are a number of other requirements designed to secure that examining bodies shall discharge their functions properly, but these need not be considered in detail. They are in all things subject to the Banking Commission.

Infractions of the law, unsafe practices and losses reducing the capital by half, if not corrected, are to be reported to the Banking Commission, as well as a state of affairs in which creditors are no longer covered by a bank's assets. The cost of examinations is borne by the

banks themselves. There is thus in Switzerland a hierarchy of examining authorities. The banks choose their own auditing associations, but these bodies are in their turn largely responsible to and controlled by the Banking Commission, to which, if required specially, they send reports on the banks they examine.

The system has certain advantages. In the first place the independent auditing association already exists and does its work well. The assurance of an unbiased examination is combined with the advantage that each bank has the privilege of selecting its own association. Secondly, the Swiss hold that banking activity is so delicate and at the same time so varied that one could not think of entrusting the control of it to the state.[1] Official control is in the interests neither of the state nor of the banks, for it implies the creation of a complicated bureaucratic organisation, and it tends to weaken the responsibility of the bank's directors and to increase that of the state. Again, the interference of state examiners would not be acceptable to customers, who attach great importance to secrecy, and would in particular displease foreign depositors,—and the latter are an important factor in Swiss banking. Thirdly, the banks do not, under this system, feel that they are having reports made against them. It was made clear when the act was passed that the detailed reports were to inform the banks of their own condition as much as to advise the commission of infractions of the law. And lastly the banks could not possibly plead ignorance as an excuse for loss or failure, if their weaknesses had already been pointed out to them, and warnings given. The Banking Commission itself, while a state-created organisation, is not a government department, and is claimed to be free of "red tape" and to constitute a supple instrument of control. The state itself, and incidentally the central bank (although this latter point is not emphasised in the official literature),

[1] Message of Federal Council to Federal Assembly, 2nd February, 1934, p. 9.

avoid responsibility. This, at least, is the published opinion of the legislators, but one cannot see how the state can avoid responsibility in a sphere in which it has undertaken to legislate.

Examiners' reports

The examiner's report, which is a report made to the bank, and is only passed on to the Banking Commission in exceptional circumstances, has to bring out clearly the general financial situation of the bank, and must state whether or not balance-sheet liabilities are covered by assets and at least half the share capital is intact. Other matters on which comment, if necessary, is to be passed include shortcomings in internal organisation and in the form and matter of the accounts, the relation between capital and total liabilities, liquidity, appropriations to reserve, foreign credits and investments (which are carefully defined) and their relation to the balance-sheet total, big foreign operations, bad and doubtful debts, reductions of capital, the total of securities received by the bank which are repledged,—and other matters in connection with which special provisions of the law exist.

The bank itself, on the other hand, must supply examiners with information as to the extent to which creditors of the bank are covered by its free assets ; the total of assets specifically charged, the credits obtained by means of such chargings and the proportion of them utilised ; the nominal value and cost price of its own shares which a bank holds ; the total value of its own shares against which a bank has made advances (including loans to purchase its shares) ;[1] the total of credits and shares the interest on which cannot be transferred into Swiss money ; the total of non-interest-bearing securities held ; unsecured personal loans to directors, managers and controllers of the bank ; the total of guarantees and indemnities given by the bank, etc.

[1] These, it will be noticed, are not prohibited, as they are so frequently elsewhere.

The act takes precautions that the report shall be duly considered by the bank, for it requires that minutes shall be written of the meeting at which the report is discussed. The writer of this chapter has not had access to any of these reports, and it is possible that they serve a useful purpose as far as the bank is concerned. It seems doubtful, however, whether they can bring to a bank's notice many points of which it is in ignorance. Nor is the bank bound in any way to act on the recommendations of such reports, except where these are concerned with infractions of the law, where the safety of creditors is compromised, or where capital is reduced by as much as 50 per cent. If steps are not taken to repair any of these three delinquencies, the bank is reported to the Banking Commission, which is then entitled to take legal action.

The Federal Banking Commission

The Banking Commission, which is appointed by the Federal Council, consists of five members and a secretariat, and its expenses are borne by the federal government. The members must be technical banking or auditing experts, but may not be active bankers or auditors.

The powers and functions of the commission are precisely defined in the law, as follows. First, the commission is the authority which decides whether or not any particular institution comes within the scope of the banking law, — whether in fact it is a bank which appeals to the public for funds. Before any bank starts business, the commission must have examined its memorandum and articles of association, and approved its organisation as being in keeping with the functions it is to discharge. It gives official recognition to auditing associations, and sees that every bank is examined once a year; it can withdraw recognition from an auditing association, if circumstances warrant this. It regulates the examination charges of the auditing associations and intervenes when any dispute arises. Again, the

commission may, in special circumstances, require copies of the examiners' reports (which are not normally available to it), and may order an extraordinary examination to be held. The only report it receives in the ordinary way is that of an examiner advising it of infractions of the law and of one or two other matters already mentioned. In such cases the commission invites the bank in question to regularise its position, or puts the matter in the hands of the competent administrative or judicial authorities.

The other functions of the commission are to modify in special cases the requirements of the law as to capital and liquidity and, in view of a provision in the act that co-operative societies may not carry on a commercial banking business, to aid already existing co-operative banks to change their constitution, and to pass judgment on what a commercial banking business is. The absence of formal contact between the commission and the National Bank is perhaps worth noting.

The commission's obligations are slight, and consist of keeping to itself any secret information that comes its way, and presenting an annual report to the Federal Council.

When we bear in mind that the Swiss Bundesrat (Federal Council) is less affected by party politics than any other executive organ of government, and that it is to the Council and not to the federal legislature that the commission is answerable, it can be seen that the Swiss banks appear at any rate to have avoided the danger of becoming involved in political controversy. Political considerations are said, however, to have played some part in the nomination of the commission. At the same time the powers of the commission are extremely limited. Apart from being invoked in cases where the law is not observed, it is little more than an arbiter between the auditing associations and the banks, and an interpreter of the law. As mentioned earlier in this chapter, there are certain provisions in the law to enable a bank to postpone payment of its liabilities, provided its creditors are covered.[1] This

[1] Two banks took advantage of these provisions in 1935.

is done in two ways which cannot be considered here as they lie outside the scope of this book, but it may be noted that the first method requires the consent of the Federal Council, and that the second is by application to a court of law, which appoints a trustee. In neither case was the Banking Commission given any function or authority, such as one might have expected, under the original law and decree. A decree of April, 1936, however, which provided for the reorganisation of banks " of considerable national economic importance " without the cumbrous legal procedure normally involved, gave the commission the task of approving schemes of reorganisation.

Credit control

Apart from the Banking Law little centralised control exists. The National Bank has no effective discount policy. Commercial banks may rediscount certain limited types of paper with the central bank, and obtain loans against collateral. Two rates are quoted by the National Bank, a discount rate and a " lombard " rate, but they are both kept as steady as possible. The official discount rate has some effect on market rates. For example, in November, 1936, the National Bank's discount rate was reduced from 2 to 1½ per cent. and the lombard rate from 3 to 2½ per cent. Market discount rate immediately declined from 1½ to 1¼ per cent. But there does not exist what one might call a regular bank rate policy. It may also be said that open-market policy, as commonly understood, is unknown in Switzerland.

Conclusion

It will be apparent from the foregoing that the 1934 Banking Law does not impose on the Swiss banks any unduly burdensome regulations and has probably had little effect on the great majority of banks. The legislators have wisely realised that a bank's stability depends principally on its directors and its officers, and on its

internal organisation; not on the measure of control exercised by outside authorities.

Capital requirements now vary between 5 and 10 per cent. of liabilities: this does not constitute a raising of the standard, for the ratio for all (217) commercial banks in 1931 was slightly over 10 per cent. Nor do the liquidity requirements involve a change of policy for the banks as a whole. So, too, the reserve funds of the banks, taken as a group, were already above the required 20 per cent. of capital in 1932. The special protection afforded to savings deposits does not, of course, affect the banks themselves, while examinations by outside bodies were already the rule rather than the exception. The law has thus for the main part aimed at codifying the existing practice of the best banks. Perhaps the most significant measure is the power given to the National Bank of vetoing big foreign operations, but this is far from being an innovation in commercial-bank control, or even in Switzerland, for there has been a tacit agreement since 1926 that commercial banks should inform the National Bank of their most important foreign operations, though this did not imply a right of veto on the part of the National Bank. More recently (November, 1937) the banks have signed a "gentlemen's agreement", at the instigation of the National Bank, not to accept foreign "flight money" or pay interest on short-term funds held on deposit. Such examples illustrate the authority of the National Bank, apart from the powers conferred on it by law.

On the other hand, mixed banking remains undisturbed, the issue of securities and dealings in them by banks for their own account go on as before, and it has not been deemed necessary to limit loans to officers and directors or the amount of credit granted to any one customer. The Swiss commercial banks are thus still comparatively free to undertake what operations they like.

THE UNITED STATES OF AMERICA

THE UNITED STATES OF AMERICA

Introduction

It is safe to assume that there is no country in the world in which banking has been more regulated than in the United States of America. This appears to be the result of a number of forces. The earlier banks of the United States were subjected to little regulation or supervision; banking was never so much the special preserve of a privileged class as it was in Europe; and there never existed the banking traditions which, in England, for example, have been passed down in the great banking families from father to son, and preserved even in our modern joint stock banks. Banking in America was, even up to the time of the civil war, in the hands of comparatively inexperienced people. The economic activities of the country, too, were rapidly expanding throughout the nineteenth century. New territory came under cultivation and exploitation, and new banks sprang up everywhere very quickly. The capital and volume of business of these "mushroom" banks were in most cases small, and they were often managed by men with no banking training at all, for there was even less banking tradition in the west than in the east. This lack of experience combined with lack of supervision made disaster—and regulation—inevitable.

Secondly, America always has been, and still is, subject to wider fluctuations in values than the older countries of Europe; variations in prices, for example, whether of manufactures, agricultural products, land or stocks and shares, are on a greater scale than elsewhere, and the banks

have thus operated under exceedingly difficult conditions. Thirdly, fabulous fortunes have been made in America within living memory, and it is one of the few countries in which it is still possible to acquire wealth quickly. In these circumstances the American people have developed a speculative outlook on life, and the banks have not been free from this or from the effects of it on their customers. The disasters to which this has led have again made legislation necessary.

A fourth factor is the continued existence in the United States of a unit banking system which, retained largely for political reasons, raises all kinds of technical difficulties and leads to the establishment by law of requirements which, in a branch banking system, are often imposed by internal rules or by instructions from the head office. Lastly, the failures of the banks, as a result of the factors mentioned in the last paragraph, have given the agricultural elements in the country, always distrustful of finance and of the development of a money power, a strong argument for the statutory regulation of banking.

Commercial banks, other than a few private banks, may be subjected to a number of classifications. First, they are all either chartered under the banking law of one of the 48 states,[1] or are national banks, chartered by the federal authorities. In December, 1936, there were 9738 state banks and 5325 national banks. Between 1864 and 1913 the two systems were in constant competition, to the detriment of banking in general. In the years immediately following the National Banking Act in 1864 the national bank code was stricter than any of the state codes, but national banks were given a virtual monopoly of note issue, and they tended to grow in numbers in comparison with state banks. As time went

[1] Some state banks are trust companies carrying on commercial banking business. Usually, however, the two departments are required to be kept separate, the trust department being governed by trust company law, the banking department by the commercial banking code.

on, however, and the value of the note-issue privilege became less highly rated, the laxer regulation of state banking proved an attraction, and many national banks took out state charters. The result, unfortunately, was a slackening of national bank restrictions (for example, in 1900 capital requirements were lowered), in order to retain adherence to the system. In spite of this, national banks, which had previously accounted in numbers for more than 50 per cent. of all banks and were still about 40 per cent. in 1900, fell to 29 per cent. in 1913 and to 26·5 per cent. in 1921. To-day, largely owing to the greater mortality of state banks in the years 1930 to 1933, national banks number about 35 per cent. of all commercial banks. In emphasising the weakening of national-bank control, however, some writers fail to notice the important effect which federal legislation (including, later, the Federal Reserve Act and amendments to it) has had on state banking law. It will be seen that state banking to-day is of a standard not far below that of national banking, and in some cases of a slightly higher standard. Many state banking laws contain passages taken word for word from federal laws.

The second classification of commercial banks, which has existed since 1913, is into members and non-members of the federal reserve system. In December, 1936, there were 6376 of the former and 8687 of the latter. National banks are compelled to become members of the federal reserve system. The Federal Reserve Act aimed at repairing certain deficiencies in the banking structure of the United States, among which the chief were the inelasticity of the bank note issue and of credit; the pyramiding of reserves in the big metropolitan banks (especially on the eastern sea-board) and the general inadequacy and inelasticity of the cash reserve system; the lack of a national clearing system, of a lender of last resort, and of a bill market. As far as the commercial banks are concerned, the main advantage of membership has been the right of rediscount with the reserve banks.

In return for this, considerably higher standards of banking than were previously observed have been exacted.

Since 1933 there has been yet another division,—of banks whose deposits are insured with the Federal Deposit Insurance Corporation, and of uninsured banks. Their numbers in December, 1936, were 13,970 and 1093 respectively. All reserve member banks are compelled to insure their deposits; for state non-member banks insurance is optional, but after 1940 all insured banks will be compelled to join the reserve system, except the very smallest state banks. The F.D.I.C. exercises an important measure of control over the banks whose deposits it insures.

A fourth, but temporary, classification is of banks a part of whose capital stock, capital notes or debentures are held by the Reconstruction Finance Corporation (of which there were 5298 [1] in December, 1936) and of banks which are not thus obligated. The R.F.C. was founded in 1932 and one of its purposes has been to provide capital for undercapitalised banks. In return for the benefits thus conferred the R.F.C. exerts a certain measure of control. Lastly, most of the bigger banks are voluntary members of a clearing-house association, and thus subject to self-imposed restrictions which are in some cases of an exacting order, especially in the big centres such as New York.

We are now to examine the control exercised by these various authorities one by one, and to come to a few general conclusions. The reader must be warned, however, that in certain matters the ramifications of banking law have become so great that there must, in the following pages, necessarily be a number of allusions which cannot be elaborated, especially allusions to some of the New Deal agencies. These have been mentioned for the sake of completeness (for example, the Home Credit Insurance Corporation on p. 392), but a full

[1] This figure is for insured banks only, but the number of uninsured banks receiving help in this way was negligible.

explanation would lead to a discussion of events quite remote from the subject in hand. Similarly, it has been necessary to presuppose a general knowledge of the structure and functions of the federal reserve system, and of its history.

CLASSIFICATION OF 15,063 COMMERCIAL BANKS, DECEMBER, 1936

5325 National banks	9738 State banks
6376 Member banks	8687 Non-member banks
13,970 Insured banks	1093 Uninsured banks

CLASSIFICATION ACCORDING TO DEPOSITS, DECEMBER, 1936
(Total Deposits of 15,063 Commercial Banks = $43,559 Millions)

In Millions of Dollars	
National banks $23,107	State banks $20,452
Member banks $35,893	Non-member $7666
Insured banks $42,158	Uninsured banks $1401

NATIONAL BANKS

Origin of the national banking system

The primary aim of those who founded the national banking system in 1863 is contained in the title of the act which established it: "an act to provide a national currency secured by a pledge of U.S. bonds and to

provide for the circulation and redemption thereof". There was in the United States in 1860 no universally accepted currency other than specie, which was exceedingly scarce, for the notes of the 1600-odd banks, chartered under the various laws of the then 34 states, were seldom acceptable outside the localities in which they were issued, and in some cases not even within them. It was the inconvenience of such a state of affairs in a country which was already becoming commercially important that was mainly responsible for the establishment of the national banking system. Other purposes which it was hoped would be served were the creation of an extensive market in government securities (which were to be deposited by the new banks with the Treasury as backing for the new currency), an improvement in the national credit (the country was at the time engaged in a civil war), and " the creation of a large number of institutions under national control, widely distributed over the country, which could not only serve as depositaries for government funds, but which could also act as the fiscal agents of the Treasury and could receive subscriptions to loans and distribute bonds to subscribers ".[1]

It will be appreciated that this act, which in 1874 became known as the National Bank Act, for long set a standard in commercial banking to which few state banking laws attained. Several of its provisions, however, were incorporated in the 1913 Federal Reserve Act and amendments to it, and thus apply equally to state member banks. Some can be more suitably considered when the control exercised over member banks of the federal reserve system is reviewed, and we shall not therefore give here a complete picture of national-bank control and legislation. In one or two instances, however, it is convenient to allude now to provisions—such as those relating to capital—which affect state member banks as well as national banks. At the same time we are to con-

[1] National Monetary Commission. *The Origin of the National Banking System*, p. 106.

sider only the specifically commercial banking functions of national banks. Thus regulations with regard to the issue of national bank notes, with which much of the original act and subsequent amendments are concerned, lie outside our scope.

Comptroller of the Currency

The act of 1863 [1] created a special bureau of the Treasury to supervise national banks, and placed it under the control of a Comptroller of the Currency, appointed by the President with the consent of the Senate, for a five years' term. The Comptroller's department, which consists of a staff of about 120 officers and clerks and over 200 bank examiners, is under the general jurisdiction of the Secretary of the Treasury, though the Comptroller himself is legally independent. It is a fact that the majority of past incumbents of this office have come from the middle west, this being attributed to popular distrust of Wall Street. The most important of the Comptroller's duties will become evident in later pages, but they may be summarised here. The Comptroller supervises the organisation, chartering and regulation of national banks; issues, redeems and regulates national bank notes; is responsible for the examination of national banks from the point of view of solvency and the observance of the act; brings suits for deliberate violations of the law; receives returns, and completes and publishes banking statistics; maintains a banking information service; gives or withholds authorisation for the merger of national banks and the establishment of branches; advises, lays down rules and makes decisions on matters relating to national banks; interprets the existing law and considers prospective banking legislation; administers, through receivers, all failed national banks, and liquidates or reorganises them; supervises

[1] This act was repealed and completely re-enacted, with certain changes, in 1864. It is therefore frequently referred to as the National Bank Act, 1864.

the trust activities of national banks. The Comptroller presents an annual report to Congress, which runs to over 800 pages.

In addition to this responsibility for the general supervision of the national banking system, the Comptroller now discharges other functions. Under the Federal Reserve Act, for example, he executes and issues the charters of federal reserve banks, and issues and redeems federal reserve notes and federal reserve bank notes. Between 1913 and 1935 he served as an *ex officio* member of the Federal Reserve Board (now the Board of Governors) but his connection with the Board is now severed. He is a member of the Board of the Federal Deposit Insurance Corporation. The Comptroller has also certain other duties in non-commercial spheres of banking, and finally is responsible for the regulation of banking in the District of Columbia. His, indeed, is a great responsibility, for on the efficiency of the control which he exercises depends to a large extent the safety of over five thousand banks and of hundreds of thousands of shareholders and depositors.

Formation and capital

Any number of persons, not less than five, may organise a national bank, provided that the articles of association and an organisation certificate (giving particulars of its name, place of business, capital, and shareholders' names and addresses) are placed before and approved by the Comptroller of the Currency. Capital must amount to at least $50,000 in cities with a population of under 6000 ; to $100,000 in cities with between 6000 and 50,000 inhabitants ; and to $200,000 in cities with over 50,000 inhabitants, with the exception that where state laws permit the organisation of state banks in the outlying districts of such cities with a capital of $100,000 or less, national banks may, with the approval of the Comptroller, be established with capital of not less than $100,000. An act of March, 1900, permitted the formation of national

banks with a capital of not less than $25,000 in communities of less than 3000 inhabitants, but the Banking Act of 1935 repealed this provision.[1] 50 per cent. of capital has to be paid up before a bank starts business, and the remainder in instalments at the rate of 10 per cent. a month. It will be noted that, unlike authorities in certain other countries, the Comptroller has no discretion in connection with the capitalisation of banks, for capital requirements cannot be varied. He has, however, considerable discretionary powers in granting or withholding charters. Close inquiries are made with respect to the need for a new bank and the character of its sponsors, and in 1930 the Comptroller was said to have been rejecting more than half the applications made.[2]

National bank stock is issued in denominations of $100 or less. Until the Banking Act of 1933 shareholders were liable to a bank's creditors for an amount equal to their stockholdings, in addition to the stockholdings themselves, but under the act of 1933 national bank stock issued after June, 1933, did not render stockholders doubly liable, while the Banking Act of 1935 provided that double liability on previously issued stock might be terminated after July, 1937, upon the giving of six months' notice. Double liability has not proved successful. It has never afforded adequate protection to depositors and has inflicted great hardship in time of emergency on stockholders of modest means. It will be noticed that under another section of the act of 1935 national banks are required to build up substantial surpluses. The advantage of this change is that it gives the depositor a more adequate protection, while limiting more closely the shareholder's liability, for surpluses must be built up out of profits and the shareholder cannot be subjected to a sudden call.

[1] There are still banks, formed between 1900 and 1935, with a capital of under $50,000. The latest published figure, that for December, 1935, is 1000 or slightly under 20 per cent. of all national banks at that time.

[2] Dowrie, *American Monetary and Banking Policies*, p. 113.

Any national bank whose capital has become impaired by losses or otherwise has to make it good by a levy *pro rata* on its shareholders, capital being defined by the 1935 act as impaired when " the sound value of the assets " of a bank is less than its total liabilities including capital. No dividends may be paid until losses and bad debts have been covered, bad debts being defined in 1864 as those on which interest is six months overdue, unless they are well secured and in process of being collected. Nor may a national bank draw on its capital for the payment of dividends : if a net loss is sustained, no dividend may be paid. There is, however, provision for the reduction of capital, provided that two-thirds of the shareholders agree and that capital is not reduced below the statutory minimum. Such reductions must receive the approval of the Comptroller of the Currency, as must any disbursements of capital made to shareholders in connection with them.

Surplus

No new national bank may commence business until it has a paid-up surplus of 20 per cent. of its capital, although the Comptroller has the right to waive this requirement in the case of a state bank being converted into a national bank, provided that the bank, before declaring a dividend on its common stock, carries at least a half of its net profits each half-year to surplus, until surplus equals 20 per cent. of capital. In addition, every national bank is required, before declaring a dividend on its common stock, to carry at least one-tenth of its net profits each half-year to surplus, until surplus equals the amount of common stock outstanding.

Directors

Every national bank must have at least five directors (and, since 1933, under the Federal Reserve Act no more than twenty-five), who must be citizens of the United States. A national bank is thus held to have

sufficient directors to prevent malpractices, but not so many that the board becomes cumbersome and the individual sense of responsibility of each is lessened. At least three-quarters of them must have resided in the state in which the bank is situated for at least a year before election, as well as during office. This residential qualification, which is found in all departments of life in the United States, is based partly on local patriotism and partly on the suspicion in which the members of one state hold those of another. There is, in particular, in the west a general fear of being controlled by the money interests of the east.

Originally each director had to hold at least ten \$100 shares, though by an act of 1905 the directors of banks with a capital of only \$25,000 were required to hold only five \$100 shares each; but since the Banking Act of 1933 the qualification has been as follows :—

At least \$2500 when capital amounts to over \$50,000.
At least \$1500 when capital amounts to between \$25,000 and \$50,000.
At least \$1000 when capital amounts to only \$25,000.

It is hoped by this increase to procure directors of higher financial responsibility, and to strengthen their interest in the success of the banks. All directors are on appointment bound to take an oath that the shares they hold are their own and unhypothecated, and that they will honestly administer the affairs of the bank.

Reserves

Up to the passing of the Federal Reserve Act in 1913 national banks were required to keep cash reserves of 25 per cent. or 15 per cent. against deposits, according as they were situated in one or other of the 3 central reserve cities and 60-odd reserve cities, or in other places. In 1913 these requirements were automatically superseded by those of the federal reserve system (see p. 415).

Permitted activities

The business of national banks has from the beginning been prescribed as follows :—discounting and negotiating promissory notes, drafts, bills of exchange and other evidences of debt, receiving deposits, lending money on personal security, buying and selling exchange, coin and bullion, and obtaining, issuing and circulating national bank notes.

In 1918 they were specifically permitted, on application to the Board of Governors of the federal reserve system (at that time the Federal Reserve Board), to undertake trust business to the extent that state laws in the states in which they are situated permit state banks and trust companies to carry on such business. They are bound, however, to segregate assets held in a fiduciary capacity, may not receive into their trust departments deposits subject to cheque, may not lend trust funds to officers, directors or employees, and must generally observe the relative state laws. Further, the Board only grants permission where the bank's capital and surplus are deemed to be sufficient, and after consideration has been given to the general condition of the bank, the character and qualifications of its proposed trust officers and the needs of the local community. About two-fifths of the national banks are today carrying on trust business.

Loans on own shares and other forbidden transactions

A bank may make no loan or discount on the security of its own shares, nor hold or buy its own shares, except where no other security is available, and any shares acquired must be sold within six months. This provision is common to most banking codes. An act of 1869 also prohibits loans on U.S. notes and national bank notes, presumably with the purpose of preventing their being quoted at a discount.

There are also limitations on dealings in corporation (i.e. company) securities and stock, but these apply to all

member banks of the federal reserve system and are described later.

Since 1907 national banks have been prohibited from making contributions to political election expenses.

Indebtedness

National banks are not normally permitted to be indebted beyond the amount of their paid-up and unimpaired capital, but there are certain exceptions, which appear severely to limit the value of the provision. Thus liabilities in respect of their own notes in circulation; deposits and items for collection; acceptances drawn against money on deposit or due; liabilities to stockholders for dividends and reserved profits; liabilities incurred under 1933 legislation to the Reconstruction Finance Corporation and to federal reserve banks, and under a 1916 act to federal intermediate credit banks; liabilities incurred under the general provisions of the Federal Reserve Act; and liabilities for certain endorsements and on account of certain loans made with the express approval of the Comptroller of the Currency, are all excluded.

Loans to one customer

There have been restrictions since the inauguration of the system on the amount which a national bank may lend to one person, partnership or body corporate. In 1864 not more than one-tenth of its paid-up capital could be so lent, but loans advanced on trade bills discounted and on commercial and business paper were excluded. By 1906 national banks were permitted so to lend up to one-tenth of their paid-up and unimpaired capital and surplus (but not more than 30 per cent. of their capital,—this presumably applying in the case of banks with very large surpluses).

As it stands to-day the law is much more involved, for while a customer's liabilities as endorser, drawer or guarantor of paper discounted by or sold to a bank are included

within the 10 per cent. of capital and surplus, the following are excluded :—bills drawn in good faith against existing values, discounts of commercial or business paper actually owned by the negotiator, obligations drawn against goods in transit, bankers' acceptances discounted, and loans to other banks approved by the Comptroller. In addition to what is lent up to the 10 per cent. limit, different classes of loans are permitted up to further percentages of capital and surplus, viz. : a customer may be liable as endorser or guarantor of non-business paper of under six months' maturity owned by himself up to an additional 15 per cent. of the bank's capital and surplus ; in respect of notes and drafts secured by shipping documents or other documents of title to readily marketable non-perishable staples and commodities up to between 15 per cent. and 40 per cent.,—according as the face value of the paper is less than the market value of the goods. Loans secured by a lien on live stock or by an equal amount of U.S. government securities, treasury bills, and securities guaranteed as to principal and interest by the government are also permitted up to an additional 15 per cent. These provisions apply in the case of a partnership jointly as between partners and partnership, and in the case of a corporation (company) as between all loans to the corporation and its subsidiaries.

It may be added that loans in excess of the lawful limit are collectable from customers, but a bank suing for such loans runs the risk of losing its charter. Directors making false reports of loans to a single customer make themselves liable to personal actions at the hands of the Comptroller.

Similar provisions are to-day found in most countries with banking codes, but nowhere are they as elaborate as in the United States.

Real estate

An important restriction on the activities of national banks concerns the ownership of real estate. Since 1864 they have only been allowed to own real estate such as is

necessary for their immediate accommodation in the transaction of business, such as is mortgaged to them by way of security or conveyed in satisfaction of debts previously contracted in the course of business, and such as is purchased at sales under judgments of the Courts to recover debts due to them. No real estate acquired for any other purpose than as premises may be held for more than five years. It will be noted that there is no restriction on the ownership of shares in real estate companies, a rather remarkable omission.

Under the Banking Act of 1933 no national bank may invest in premises in excess of its capital, except with approval of the Comptroller of the Currency. This restriction is exceptionally liberal, the average value of premises in England and Canada being nearer 30 per cent. of capital.[1] A similar restriction applies to all member banks of the reserve system.

Before the passing of the Federal Reserve Act in 1913 national banks had no authority to make loans on the security of real estate, though there was no definite prohibition of such loans. In 1913, however, mainly at the instigation of members of Congress representing agricultural interests, loans on real estate up to 25 per cent. of capital and surplus or one-third of time deposits became permissible, provided that they did not exceed 50 per cent. of the actual value of the property mortgaged, and were not made for more than five years. Even so, national banks in central reserve cities were not included in the authorisation, and the land was required to be improved and unencumbered farm land, situated within the lending bank's federal reserve district or within 100 miles of the bank. In 1927, under the McFadden Act, the restriction was made less severe, and further liberalisation followed with the National Housing Act of 1934 and the Banking Act of 1935. This more

[1] Although there have been cases of extraordinary ostentation in premises, the premises of national banks taken as a whole are worth between 35 and 40 per cent. of capital only.

recent legislation was bound up with New Deal expansionist policies designed to encourage loans to property owners for the purpose of effecting improvements.[1] As the act now stands, national banks may make loans secured by first liens on improved real estate, including improved farm lands and improved business and residential properties. The security must be in the form of a mortgage, trust deed or similar instrument. The amount of any such loan, however, may still not exceed 50 per cent. of the appraised value of the real estate offered as security, and no loan is normally to be made for more than five years. Loans amounting to as much as 60 per cent. of the value and for up to ten years, however, are permitted, if they are secured by instruments under the terms of which instalment repayments are sufficient to amortise 40 per cent. or more of the principal within 10 years. The above restrictions do not apply to loans contracted before 1934, or to loans insured under the special provisions of the National Housing Act of 1934 (by which, if mortgages are insured with the Home Credit Insurance Corporation, loans may exceed 50 per cent. of the value of the property). A further restriction is that no national bank may make real-estate loans (apart from those in the two categories just mentioned) in excess of its unimpaired paid-up capital and surplus or of 60 per cent. of its time and savings deposits, —whichever is the greater. This is inoperative at the present time, as real-estate loans are to-day less than 20 per cent. of time and savings deposits.

The National Housing Act also permits loans for the construction of farm and residential buildings, which, provided that they are of maturities of not more than six months, are not included in the category of real-estate loans even if so secured, but are classed as ordinary commercial loans. But such loans may not exceed 50 per cent. of paid-up and unimpaired capital. Loans made

[1] At the end of 1936 about 20 per cent. of the loans of American banks were secured by real estate.

to industrial or commercial businesses which are wholly or partly discounted or purchased by, or pledged with, federal reserve banks or the R.F.C. are also excluded.

The chief argument against real-estate loans is, of course, not the danger of loss (which can easily be offset by the imposition of a wide margin between the amount of the loan and the value of the land), but the delay which necessarily attends realisation. Not infrequently banks have been compelled to suspend payment at times when the value of their assets fully covered their liabilities, but the large proportion of assets consisting of bad debts on real-estate security made it impossible for them to realise in emergency. Even so, it is curious that the original Federal Reserve Act prohibited real-estate loans by national banks in the central reserve cities, for urban land is usually better security than farm land. To crystallise current American opinion on this topic, time or savings deposits may safely be employed in loans on the security of land, but not deposits repayable on demand.[1] In England, of course, no security is more highly rated than land, but English bankers appear to attach more importance than American bankers to their customers' ability and undertaking to repay. The necessity of realising security is looked upon as a mark of bad banking. When a banker will not lend on any security, however good, unless he thinks that the customer can repay without realising the security, the liquidity of the security taken is of less immediate importance, though, of course, its ultimate realisable value is still an important factor. In short, it is the liquidity of the loan rather than of the security which engages the English banker's attention.

The liberalisation of the law concerning real-estate loans in the United States is against the main current of banking legislation in 1933 and 1935, though in keeping

[1] It is presumably for this reason that the permitted percentage of real-estate loans is related to capital or to time deposits, not to total deposits.

with New Deal philosophy, and it has still to be tested in a time of stress.

Branches

There was no provision in the original act for the establishment of branches by national banks, but a law of 1865 permitted state banks which became national banks to retain their branches. In 1892 and in 1901, on the occasions of big exhibitions, national banks in Chicago and St. Louis respectively were permitted to open branches in the exhibition grounds, but in each case they were only operated for two years. The opening of new branches by national banks was first permitted by the McFadden Act of 1927, the provisions of which were as follows. National banks were allowed to continue to operate branches already open (of which there were at the time 372), and state banks converted into or consolidated with national banks were confirmed in their right to retain branches. Equally, two national banks merging were allowed to operate as head office and branch. Finally, national banks might, with the approval of the Comptroller, establish new branches, where state laws allowed state banks to do so, within the limits of the city, town or village, or even of the state, in which they were situated. Only national banks with a paid-up and unimpaired capital of at least $500,000 may open branches outside the city, town or village in which they are situated, except that, in states with a population of under one million and with no cities with a population of over 10,000, the capital need amount only to $250,000. In states with only half that population the capital need only be $100,000. In all cases, however, the aggregate capital of every national bank and its branches must be sufficient to sustain an equal number of national banks ; and branches may not be established or moved without the Comptroller's approval. The act also made provision for the establishment of seasonal branches. It will be seen that the McFadden Act did not make the operation

of branches particularly attractive, for one of the main advantages of a branch system is that it economises capital. Consequently the number of branches operated by national banks in October, 1936, only amounted to 1460. Of over 5000 national banks only 190 had branches.

The opening of foreign branches is regulated by an act of 1916. The permission of the Board of Governors of the federal reserve system must be obtained, and a capital and surplus of at least $1 million is required. Reports of condition of such branches must be furnished to the Comptroller on demand, and they are subject to special examinations. Accounts are to be separately conducted and the profit or loss of each branch is to be transferred as a separate item at the end of each financial period to the books of the parent bank. Similar provisions govern the ownership of stock of banks engaged in foreign banking, and in no case may a national bank so invest more than 10 per cent. of its paid-up capital and surplus. The Board of Governors of the reserve system has the power to restrict all foreign business of which it disapproves.

National banks as agents

A national bank may act as agent for an insurance company situated in the state in which it transacts business, and as a real-estate loan broker (of property situated within a hundred miles of its place of business),—only, however, with the permission of the Comptroller of the Currency, and in towns of under 5000 inhabitants. The banks are prohibited from guaranteeing to any insurance company the truth of any statement made by an insured person, or the payment of premiums on insurance policies issued through their agency by their principals. Nor may a national bank guarantee the payment of either the principal or the interest of any real-estate loan which it helps to effect.

Emergency Banking Act of 1933: reorganisation of banks

The Emergency Banking Act contained provisions for the conservation of national banks during and after the emergency of March, 1933. These provisions are now no longer of practical importance. The section dealing with the reorganisation of national banks, however, is still of interest. No reorganisation may take place unless the Comptroller is satisfied that the plan is fair and equitable as between depositors, creditors and stockholders, and is in the public interest. He may prescribe restrictions, conditions and limitations. Further, the consent in writing of certain proportions of depositors, creditors and shareholders is required. Most banking codes provide some such safeguard and there are comparable provisions in the English Companies Act.

Interest on deposits

National banks may not pay a higher rate of interest on deposits than the maximum authorised by law to be paid on deposits of state banks and trust companies in the states in which they are situated. There was formerly, in addition, a maximum rate of 7 per cent., but this no longer holds good. As will be seen later, the rate of interest on time deposits is now fixed for all member banks by the Board of Governors, and they may not pay any interest at all on demand deposits. This provision of the National Bank Act has, therefore, in practice, been superseded.

Reports

Every national bank is required to make at least three reports of condition a year to the Comptroller on a form supplied by him. The Comptroller may also call for special reports. All reports must exhibit a bank's position at the close of business on any day specified by the Comptroller, and be published by the bank at its own expense in a local newspaper. Since the Banking Act

of 1933 national banks with affiliates (including holding company affiliates) which are not member banks must at the same time produce reports of condition of their affiliates [1] and give any information that is required as to their relations with them. National banks must also furnish reports of their dividends and net earnings after each declaration of dividend, and semi-annual returns for tax purposes of their average note circulation, deposits and capital (on which they are taxed respectively ½, ¼ and ¼ per cent.).

Examinations

Under the 1864 act the Comptroller may appoint examiners " who shall have power to make a thorough examination into all the affairs of the association (i.e. bank) and in doing so to examine any of the officers or agents thereof on oath ; and shall make a full and detailed report of the condition " of the bank. Such examinations extend to affiliates other than member banks, and must be made at least twice a year. Recommendations and suggestions are made to the banks concerned, where necessary, and if the banks do not comply within 120 days, the Comptroller has the right to publish his reports on them. All examination expenses fall on the banks themselves.

The organisation of national bank examinations has been described as follows : [2]—" The examination and immediate supervision of national banks has been placed upon a relatively efficient basis, by dividing the country into twelve districts, coterminous with the Federal Reserve districts, with a chief examiner and his staff in charge of each. The staff assembles in the office of the chief twice a year. Reports are presented covering the conditions present in every unsound bank in the district,

[1] This raises some interesting speculations. At the American Bankers' Association Convention in 1933 it was stated that one national bank was owned by a packing company which controlled 200 other companies at home and abroad : another was owned by a church which controlled a hospital and an orphanage, etc. Another bank foreclosed on a housing corporation which thus became its affiliate.

[2] Dowrie, *American Monetary and Banking Policies*, 1930, p. 116.

credit information is exchanged, and methods of strengthening the system of inspection and supervision are discussed. Each national examiner is expected to examine, on the average, seventy moderate-sized banks. In the case of large institutions assistance is provided. The chief examiner makes up a report for each bank, obtains the examiner's signature, and undertakes to reconcile inter-bank transactions by a comparison of statements. Copies are furnished to the Comptroller, the local Federal Reserve Bank, and the officers of the examined bank."

For an account of examinations in general, in the light of more recent experience, the reader is referred to p. 465.

Conclusion

The record of the national banks compares favourably with that of state banks. Between 1921 and 1932 as many as 612 national banks suspended payment, but failures among state banks amounted to 8716. An average of 1·8 per cent. of all national banks annually suspended payment, against an average of 4·0 per cent. of all state banks. Although, however, the mortality of state banks was about two and a half times as great as that of national banks, the record of the latter can hardly be a matter for pride. Even so, it appears that the legislation governing national banks affords about as much protection as any set of externally imposed rules can be expected to do, unless supervision is to intrude much more on the private affairs of the banks.

The reader will recall that all national banks are members of the federal reserve system ; thus the control exercised over national banks has not yet been fully examined.

State Banks

Supervision

The banking laws of the 48 states, if put together, would fill several thousand pages. The impossibility of reviewing this mass of legislation has led the writer to

confine his attention to the laws of four representative states,—New York, Illinois, Kansas and California. Between them, it is safe to assume, they present a fairly good picture of state banking, though possibly their provisions are rather above the average in strictness. Even these four states have to be dealt with cursorily, only the most interesting sections of their laws being considered.

State banking laws appear to the English reader to be a curious combination of civil and criminal law, dealing with such diverse matters as the law of bills of exchange, slander, trusts, forgery, bank robbery and larceny, taxation, bankruptcy, embezzlement, banker and customer, local government finance, etc., to mention the contents of a few sections taken at random. There is, in particular, much on the liquidation of failed and insolvent banks which does not concern us here. We attempt, therefore, in the following pages to consider only those provisions relating to control. It must, however, again be emphasised that only four state laws are reviewed, and that, in particular, that of New York is of an especially high standard.

The normal state authority consists of a state banking department in the charge of a bank commissioner or superintendent, appointed by the governor of the state for a fixed term. He must have no banking connection or interest, though banking experience is sometimes required. Under him is a force of examiners. In states (e.g. New York and Kansas) where there is a banking board, the members of which are partly or wholly selected by the banks, he acts as the board's chairman and executive head. The board may have collective powers, as in New York, or be merely advisory, as in Kansas. The superintendent is responsible to the governor and it is he or the board that grants permission, in cases (referred to later) where permission is required for certain activities. It is he also who controls the establishment of new banks. The banking department itself is financed by assessments on the banks.

The powers of the New York banking board are prescribed

as follows :—to regulate the methods and standards of bank examinations, to define what is unsafe business or an unsafe position, to prescribe rates of interest on deposits, to limit and regulate withdrawals of deposits, to postpone or omit calling for reports, to vary the requirements of law provided the spirit is followed, to establish safe methods of banking, and to summon and remove officers and directors of banks for continuing violations of the law or unsound practices, after they have been warned. In the latter connection the board may issue orders to banks to discontinue unlawful or unsafe practices, to make good any impairment of capital or encroachment on legal reserves, and to keep their books as it prescribes. The law declares that it is the policy of the state that supervision by the banking department shall be such as " to insure the safe and sound conduct of business, to conserve the assets (of banks), to prevent the hoarding of money, to eliminate unsound and destructive competition, and to maintain public confidence ". In Kansas, where the board's powers are purely advisory, the commissioner has the power to remove dishonest, incompetent or reckless bank officers, and to revoke a bank's authority to transact business if it does not comply with his lawful requirements. In California there is no banking board and the superintendent has more restricted powers. He is, however, responsible for examinations and may take possession of a bank guilty of unsafe, unauthorised or illegal practices, of a bank which refuses to permit examination, or is in an unsafe condition ; or even if he concludes that " it is unsafe or inexpedient for it to continue business ". The various state authorities, in short, give the banks their charters, deprive them of them in certain circumstances, and are always responsible for their winding up.

Examinations

Examinations are regularly conducted : in New York at least twice every fifteen months (though the report of a clearing-house examination may be accepted instead) ;

in Kansas at least twice a year ; in California and Illinois at least once. In New York and Kansas affiliates may also be examined, and in all cases special examinations may be made. In New York the superintendent may publish his report on a bank examination if he thinks fit. Reports of condition to the authorities are also required : in California at least three a year, in Kansas, New York and Illinois four ; and provision is usually made for their publication in a local newspaper. In some cases other statements are required, e.g. of dividends paid, of amounts carried to surplus each year, etc., and reports of branches and affiliates. In New York and California the directors of a state bank are compelled to conduct an internal examination every six months (unless the bank is a member of a clearing house) and every year respectively ; detailed reports of these must be sent to the state department.

Capital, directors, premises and branches

Capital requirements, as is usual in the United States, depend on population : banks may be chartered in Kansas with as small a capital as $20,000, in New York $25,000 and in the other two states $50,000. In California, in addition to requirements based on population, every bank must have a paid-up capital and surplus equal to 10 per cent. of its deposits up to $1 million and 5 per cent. of deposits in excess of this. Capital has always to be fully paid up and surpluses must be built up by regular annual allocations from profits, usually to 20 or 25 per cent. of capital (in Kansas 50 per cent.).

Capital requirements in the states as a whole are still dangerously low. Of the 10,816 banks which failed in the twelve years 1921–32, 3652 were state banks having a capital of less than $25,000. A further 2486 had capitals of just $25,000.

There are usually between five and twenty-five directors (in New York smaller banks may have only fifteen), the majority of them local residents ; and under some laws

they are required to hold at least a given number of meetings a year. In Illinois an "oath of fealty" to the bank is required and a similar provision exists in other states. The usual holding of shares is $1000; in Kansas it is $500, but the qualification is extended to cashiers and managing officers as well. In Kansas, too, all employees having the care and handling of a bank's funds must give a bond executed by a surety company, the expense being borne by the bank.

Premises are usually the only form of real-estate ownership permitted, except such as is entailed in collecting debts or at sale under judgment. The value of premises in Kansas and California is limited to a half of capital and surplus. Real estate acquired other than as premises may be held in Kansas and New York for five years only, in the other two for ten years.

Branch banking is widespread in California, but branches involve additional requirements as to capital and there are important regulations with regard to their establishment, removal and termination. In New York branches may be opened, with the permission of the superintendent, in the town in which a bank's head office is situated or in villages in which no other bank exists; only banks with over $1 million capital may open branches outside the state. Branch banking is prohibited in Kansas and Illinois. Consolidation of banks within the same county of the state of Kansas is permitted, however, and it appears that a bank may thus have two or more offices. Consolidation is also permitted, under conditions, in Illinois. It is safe to say that in no state may a bank change its place of business or its name without permission of the state banking authority.

Reserves against deposits[1]

In New York reserves against demand deposits are as follows:—

[1] For a comprehensive account of all state laws governing cash reserves, see *Federal Reserve Bulletin*, March 1937, pp. 188-219.

In towns of over $1\frac{1}{2}$ millions population, 18 per cent. (of which 12 per cent. in cash).

In towns of 1 to $1\frac{1}{2}$ millions population, 15 per cent. (of which 10 per cent. in cash).

In towns of under 1 million population, 12 per cent. (of which 4 per cent. in cash).

(No reserves are required by law against time deposits.)

Of the legal cash holdings of 12, 10 or 4 per cent., anything in excess of 4 per cent. of deposits may be with a federal reserve bank. Member banks of the federal reserve system are exempted from all the above requirements. Banks encroaching on legal reserves are subjected to assessments at specified rates on the amount of the encroachment. These rates vary between 6 and 12 per cent. per annum.

In Kansas all banks must hold a reserve of 15 per cent. against demand deposits and 5 per cent. against time deposits. Half of this must be in the form of cash or of deposits with other banks, the rest in U.S. or municipal bonds, or the bonds of corporations engaged in business for ten years, secured by property worth more than twice the amount of the bonds. Banks are not permitted to make new loans or to declare dividends while their reserves are below the legal minimum, and banks failing to restore reserves are deemed to be insolvent. The bank commissioner is empowered to suspend reserve requirements for short periods.

In California reserves are to be kept against all deposits other than postal savings and the reserves of public municipal authorities (which are specially protected otherwise), as follows :—

18 per cent. in banks with principal place of business in a town of 100,000 inhabitants.

15 per cent. in banks with principal place of business in a town of 50,000–100,000 inhabitants.

12 per cent. in banks with principal place of business in a town of under 50,000 inhabitants.

Of these reserves 6 per cent. of deposits must be gold bullion or currency, the remainder may be deposited with specially designated banks. It is, however, open to any bank to deposit all or any part of its reserves with the federal reserve bank in whose district it is situated. Penalties of between 6 and 12 per cent. per annum are levied for encroachment on reserves. Banks which are specially designated as reserve depositaries are required to keep higher reserves.

Although in the three cases cited reserves appear at first to be above those required of federal reserve member banks (see p. 415), they are in fact lower, for they include deposits with other banks or are partly in the form of bonds.

Restrictions on assets

There are in all four banking laws under consideration restrictions on loans to one person or corporation. In New York only 10 per cent. of capital and surplus may be lent in any form to any one customer, with the exception that greater latitude is allowed in the case of certain specific types of collateral, certain specific borrowers (e.g. a foreign nation, a railway company), and banks in boroughs of specified population. In Illinois the limit is 15 per cent. of paid-up capital and surplus or 30 per cent. of paid-up capital, whichever is the lower, but bigger loans are permitted against certain types of bills discounted and mortgages on productive real estate worth double the amount of the loan made against them. Losses incurred through violation of this section of the law are deemed to be the personal liability of the officer or director involved. In Kansas, too, there is a limit of 15 per cent. of capital and surplus (excluding the discount of bills drawn against existing valuable goods). In California there is no such provision, but others exist : no bank may invest over 5 per cent. of its assets in any one bond issue (except in the case of public bonds) ; nor accept as collateral for loans more than 25 per cent. of the capital

stock of any other bank ; nor lend more than 10 per cent. of its assets on the capital stock of any corporation whatsoever ; nor lend more than 35 per cent. of its assets on real estate,—and even so it must hold a first mortgage and the security must exceed the value of the loan by specified percentages, according to the period of the loan.

In Kansas no bank may invest funds in the stock of another bank or corporation (except in a bank engaged in foreign business). In New York no bank may hold as collateral over 10 per cent. of the stock of any other " moneyed corporation ".

Other limitations found in almost all state bank laws are those on loans to officers and loans on a bank's own shares. In the case of New York no bank (nor the officers, directors or employees of any bank) may purchase its own obligations at less than face value, nor may it make loans for the purpose of purchasing its own stock, except on security of a value of at least 115 per cent. of the amount of the loan. In California banks may neither lend on nor invest in their own stock, unless this is necessary to prevent loss.

Loans to directors and officers are permitted in Illinois, given the approval of a bank's board of directors ; in New York the written approval of a majority of the board is required, except in the case of loans on U.S. bonds. In Kansas loans may not be made to any one officer or employee in excess of 5 per cent. of capital and surplus, and in excess of 10 per cent. in the aggregate. In California loans may be made to directors, agents and employees, but not to officers or to concerns in which they are majority shareholders. Even permitted loans must be reported to the superintendent of banks, unless they are very small.

The restriction on real-estate loans in California has been mentioned above. In New York there are restrictions on loans on second mortgages, and the total of real-estate loans may not exceed specific percentages of capital and surplus, —fixed according to the population of the community in

which the bank is situated. There is no restriction on real-estate loans in Kansas.

A type of asset more common in American than in English banking is deposits with other banks. It has been seen that in some cases reserves partly take the form of deposits with other banks specially designated as reserve depositaries. In New York, however, not more than 25 per cent. of a bank's capital and surplus may be deposited in another bank, except in a designated depositary, in which case 50 per cent. may be so placed. In California national banks holding the deposits of state banks are subject to state examinations.

Dealings in securities are most regulated in Kansas. Here the banking commissioner has the right to define "investment securities" in which a bank may invest. He has laid down that buying and selling must be without recourse (thus ruling out repurchase and resale agreements); that securities must be "marketable" (i.e. not small local issues); must be negotiable and contain a promise to repay at a fixed date, and must be in the form of bonds or notes. There are further detailed requirements in the case of railroad, public utility, industrial, foreign government and real-estate mortgage bonds, and the commissioner may pass judgment on the eligibility of any bond. There is also a limitation on investment in the obligations of any one obligor (10 per cent. of capital and surplus) similar to that already noticed in the case of California. New York, on the other hand, is the only one of the four states in which commercial banks are restricted in their dealings with security affiliates (i.e. companies engaged in buying, selling, issuing, underwriting or distributing securities). Security affiliates are not forbidden, but loans to them, investments in them, repurchase agreements with them and advances against their stock are limited in the aggregate to 20 per cent. of each commercial bank's capital and surplus. All loans to affiliates must be secured by collateral exceeding the amount of such loans by specific percentages in marketable value. As will

be seen later, however, none of the state laws goes so far as federal reserve law in the control of securities and security affiliates.

Certain other restrictions on assets prevail, but a few examples of these will suffice. In Kansas banks are only permitted to hold chattels acquired in the satisfaction of debts for six months. Banks are also expressly forbidden to engage in trade or commerce. In New York there exist detailed rules as to the valuation of assets for balance-sheet purposes. In Illinois loans to bank examiners are prohibited. In California banks wishing to borrow may pledge their assets, but only in limited ways and to a limited extent ; bad debts are sharply defined and the law states how and when they are to be written off. No bank in California may carry assets in its balance sheet at more than cost ; banks with different departments (e.g. a savings or trust department) must keep the assets of each department separate ; overdrafts of more than ninety days are not permitted to stand as assets, and so on. Many of these restrictions, it must be agreed, are reasonable enough.

Directors, officers and employees

Apart from the question of loans, several other rules affecting officials exist. In New York bank directors and officers are prohibited from concurrent employment in any business engaged in buying and selling securities, except with a permit from the state authorities. A director who is himself a borrower or has guaranteed another's loan must file a statement of his financial position with the bank at least once a year, except where the collateral is 15 per cent. above the amount of his obligation. Officers must report to their banks any debts they have contracted at other banks. Officers and directors may be summoned and removed by the banking department for continued violations of the law or unsound practices. In Kansas officers found by the commissioner to be dishonest, reckless or incompetent must be removed.

Any officer accepting a deposit when his bank is in a failing condition becomes individually responsible for any loss the depositor—and his executors after him—sustain. The receipt of gifts and fees in connection with loans is a criminal offence. In California it is a felony for any officer, director or employee to receive commission or overdraw his account. Nor may they purchase assets from their banks at less than market value.

Miscellaneous

Other sections of the law may, as a matter of interest, be mentioned *seriatim*. There is usually a provision for the making good of impaired capital by assessment on shareholders (who are also usually subject to double liability). Banks are sometimes permitted to borrow for short periods within limits, but not in order to re-lend. Dividends are usually payable only out of net profits. In Kansas it is a criminal offence maliciously to circulate a rumour with the object of causing a run on a bank. Special arrangements are usually made for the protection of state or municipal deposits, by the lodging of security by the banks or the giving of bonds. In New York the rate of interest on loans and discounts is limited to 6 per cent. Books and records of final entry must be kept for at least six years. A list of deposits, dividends and interest unclaimed during the preceding five years must be published on the 10th September in each year. In New York, too, the law ordains that all books, accounts and records must be kept and entered in the English language.

This scant description of some of the more interesting features of four state banking laws shows that they are in some respects more comprehensive than either national bank law or federal reserve law. But it will be apparent later that while they may generally stand comparison with the former, they do not usually go so far as the latter. As national banks are compulsorily members of the federal reserve system, it follows that the standard

of banking in state banks taken as a whole is still not as high as that in national banks.[1] There is nothing to choose between the better banks of each type or between national banks and state member banks. It is not law, but policy which makes for good banking. While, however, the results which legal safeguards have achieved in the past have been unimpressive, it is clear that they must make impossible or at any rate difficult some of the grosser abuses.

The Federal Reserve System

The Federal Reserve Act

The objects which the federal reserve system was founded to achieve have already been briefly summarised (p. 379). For a general account of the system the reader is referred to other works, such as Burgess's *Reserve Banks and the Money Market.*[2] The Federal Reserve Act was originally passed in 1913, but there have been only five years since that date in which there has not been some amendment to it, and in some years it has been revised by as many as six distinct pieces of legislation. The three chief amending acts were those of 1927, 1933 and 1935. The first, perhaps best known as having extended the branch banking activities of national banks, in fact restricted those of state member banks. The second was concerned primarily with the regulation of holding company affiliates, loans on stocks and bonds,

[1] State banks which are members of the federal reserve system are, of course, subject to two sets of laws. It sometimes happens that in some respects state law is more exacting than national bank or federal reserve law, though less severe in other respects. In such cases state member banks, bound to observe in each case the more exacting code, are more restricted than either national or state non-member banks. Sometimes, however, special provisions are made; for example, the statutory cash reserves of New York State banks are higher than those of member banks of the reserve system, but the state law only demands of state member banks that they should meet federal requirements.

[2] Harpers. Revised edition, 1936.

investment operations, loans to officers and affiliates, the divorce of security affiliates, and the general tightening up of control. The act of 1935 was concerned largely with the structure of the reserve system and the powers of the Board of Governors, but there were technical changes affecting member banks and these are referred to in the following pages.

All national banks are required by law to be members of the federal reserve system. State banks may apply for membership, but are admitted only after the Board of Governors of the system (referred to hereafter as the Board) has considered their financial condition, the general character of their management, and whether or not their corporate powers are consistent with the Federal Reserve Act. Whether applications for membership are at all frequently refused is not disclosed in official literature.

Capital

State member banks are required to have sufficient capital to become national banks, except that state banks situated in places with under 3000 inhabitants and having a capital of between \$25,000 and \$50,000 may be admitted, provided that they were established prior to June, 1933.[1] Banks insured by the Federal Deposit Insurance Corporation which are situated in places with under 3000 inhabitants and have less than \$25,000 capital may become members, if they make their capital up to this lower limit (i.e. \$25,000). The Board has the right in the case of very small insured banks (which under section 12 B(y) of the Federal Reserve Act are required[2] to become member banks if they are to have the benefits of insurance) to permit operation with even less capital, provided that in the Board's opinion

[1] In December, 1935, there were only 223 state member banks with a capital of under \$50,000. This, however, was 22 per cent. of the total number of such banks.

[2] By December, 1941.

such capital is sufficient. It will be noticed that in this matter the Board has more discretionary powers than the Comptroller of the Currency (see p. 385).

It may be stated here that state member banks must conform to the rules imposed on national banks with regard to the withdrawal or impairment of capital and the payment of dividends when a net loss has been sustained (see p. 386).

Directors and officers

The directors and officers of federal reserve member banks are subject to an important degree of control. Some of the restrictions are self-explanatory, such as those which require every state member bank to have the same number of directors as national banks are required to have, and directors themselves to hold the same number of qualification shares as the directors of national banks. Other requirements need further explanation.

First, no officer, director, partner or employee of any company, association or partnership, and no individual, engaged in the issue, flotation, underwriting or distribution of securities may serve at the same time as a member bank officer, director or employee, except in limited cases permitted by the Board, where it considers that this would not unduly influence the investment policy of the bank or the advice given to customers regarding investments. This is a logical consequence of the inability of a member bank to affiliate with a securities company, which results from a provision of the Banking Act of 1933 and is described later.

Secondly, under the Clayton Anti-Trust Act, 1914, as amended (and especially by the Banking Act of 1935), no member bank officer, director or employee may serve in any other bank except with the special permission of the Board (even so only in one other bank), which may be given in cases where the second bank is one in which over 90 per cent. of the stock is owned by the United States or

by a corporation of which the United States owns directly or indirectly over 90 per cent. of the stock; which is in course of liquidation; which is engaged principally in banking abroad; which has no office or branch in the same locality as that in which the member bank or any of its branches is situated or in an adjacent locality; which is not engaged in the same class of business as the member bank; which is a mutual savings bank with no capital stock; or in which over 50 per cent. of the common stock is owned directly or indirectly by persons owning directly or indirectly over 50 per cent. of the member bank's stock. Member bank officers and directors serving in August, 1935, in a second bank not included in the above categories are permitted to continue so to serve up to 1st February, 1939. This provision, which has its counterparts in other fields of economic activity, is aimed against the development in the United States of a " money trust " which, through a system of interlocking directorates, might come in time to control a large proportion of the country's banking resources. Up to 1935 the Clayton Act was not very effective in curbing chain banking because, although it did not admit of so many exceptions to the general rule as it does under recent amendments, it applied only to the larger institutions, which were not generally interested in building up chains of banks. Further, even where a majority shareholder of many banks cannot nominate the same directors for each, he still controls the nomination of directors in all of them. Small banks are not to-day excluded from the provisions of the act, but it still only applies to member banks. It will be seen later that precautions have been taken under recent legislation against some of the worst abuses of group and chain banking.

A more important provision, which is one of the chief innovations introduced by the Banking Act of 1933, is as follows. The Comptroller of the Currency and the twelve Federal Reserve Agents are authorised to report to the Board the directors and officers of respectively national

and state member banks who, after having been warned, have continued to violate any law relating to their banks or have continued unsafe or unsound practices. In such cases the Board may summon officers and directors before it and, if necessary, remove them from office. This marks an important advance in the weapons at the disposal of the supervisory authorities. They have for long had the power to suspend the charters of national banks and to expel state member banks from the system, but this was far too drastic a step to take in any but exceptional circumstances, and the fixing of personal responsibility on directors and officers should be a powerful deterrent to violations of the law. This power to remove officers may be regarded as the application, under a unit bank system, of one of the chief advantages of a branch banking system. Scepticism is, however, still expressed in some quarters, of its effectiveness in practice. In the absence of an official definition, it is impossible to give a precise meaning to the phrase " unsafe or unsound practices ", and it is clearly capable of very varied interpretations.

Transactions between member banks and their directors, officers and employees are also regulated. Under the Federal Reserve Act the Board has the right to full information with regard to sales of securities by directors to their own banks. The sale of property to directors by their own banks is permitted, provided that it is not carried out on specially favourable terms. Directors, officers and employees are not to be paid interest on deposits at rates in excess of those ruling for ordinary customers.

As a result of provisions in the Banking Acts of 1933 and 1935 member banks may not extend credit exceeding $2500 to any of their own executive officers, but loans made before 16th June, 1933, may be renewed up to June, 1938, provided that the directors consider it to be in the best interests of the bank, and the officer in question has made reasonable efforts to reduce his debt. The restriction

applies to partnerships in which such an officer is partner, but does not prohibit an officer from guaranteeing or endorsing any third party's debt to his own bank contracted previously and in good faith, for that bank's protection. Officers may also incur indebtedness to their own banks, with a view to protecting them against loss or giving them financial assistance. Any member bank officer borrowing from a non-member bank must report the transaction to his own board of directors, giving full particulars of the loan.

The new provisions are designed to prevent the serious abuses which were previously a frequent cause of failure. A survey made by a committee of the federal reserve system in 1933 showed that while in 1930 a number of sound active banks had loans outstanding in the names of their directors and officers to the extent of 7 per cent. of capital and surplus, a group of banks which failed in the following year had lent on the average as much as 38 per cent. of capital and surplus in this way, and had thus been employing an increasingly large proportion of their funds since 1920. Banks are still not prohibited from making loans to their own directors. The rule that officers must report loans made to them by other banks was imposed because several failures had been due to bank officers getting into debt and indulging in peculation.

Premises and branches

No member bank, unless it has the permission of the Comptroller of the Currency or (if it is a state member bank) of the Board may invest in bank premises, or in the obligations of a corporation owning its premises, or make loans on the security of such obligations, in excess of its capital. This provision was introduced by the Banking Act of 1933. Previously banks had sometimes invested in premises far beyond their needs, either for sheer ostentation or in order to augment income by letting part of such premises. This had in many cases resulted in substantial losses.

The regulations as to opening branches are materially the same for state member banks as those applying to national banks and discussed on p. 394; with the modification that the approval of the Board is required wherever that of the Comptroller is needed in the case of national banks.

Cash reserves

Under the provisions of the Federal Reserve Act member banks are required to maintain with a federal reserve bank the following percentages of their demand deposits by way of reserve :—

Central reserve city banks [1] .	At least 13 per cent.
Reserve city banks . .	,, 10 ,,
Other member banks . .	,, 7 ,,

Banks in the two central reserve cities and in the sixty-odd reserve cities may, with the permission of the Board, if situated on the outskirts of such cities, maintain only such reserves as are appropriate respectively to reserve city and in some cases country banks, and to country banks. In all cases reserves of 3 per cent. are to be kept against time deposits (i.e. deposits withdrawable at more than thirty days' notice).

Under the Banking Act of 1935 the Board was authorised to increase all reserve requirements, up to twice the percentages mentioned above, in order to prevent injurious credit expansion. They may also be lowered again, but never below the statutory limits. Such changes may affect either all member banks or member banks in central reserve and reserve cities only. In July, 1936, the Board raised all reserves by 50 per cent. In January, 1937, they were all raised again by a further $33\frac{1}{3}$ per cent., i.e. to 26, 20, 14 and 6 per cent. The upper limit has thus now been reached.

[1] There were formerly three of these, but now only New York and Chicago are so designated.

It will be noticed that the reserves of member banks have three characteristics :—

(1) they are statutory reserves ;
(2) there is differentiation between the reserves of town and country banks ;
(3) bigger reserves are required against demand than against time deposits.

The first characteristic, coupled with the ineligibility of till money to be reckoned as statutory reserve, means that member banks carry larger reserves than the law necessitates, though on the other hand the mere existence of a legal minimum is said to militate against bankers using their discretion. This, of course, might also be said to be a weakness of nearly all statutory regulation, and the tendency, always existent in the case of cash reserves, has possibly been strengthened by the recent legislation which empowers the central authorities to vary the reserve ratios ; for, if anything, it must confirm in the minds of those who direct and manage member banks the belief that they are relieved of the responsibility of thinking about cash reserves. As soon, however, as it is recognised that statutory reserves are not reserves which assure liquidity in face of withdrawals through the clearing or at the counter,—and there is no reason for believing that American bankers do not recognise this,—the objection disappears. As it happens, it is possible in America to allow reserves to sink temporarily below the legal limit, on payment of interest on what is, in effect, an advance from a reserve bank. It may be added here that if a bank's reserves fall below the minimum, it may not make a loan or pay a dividend until the reserve is restored.

Statutory reserves have the advantage of making central-bank credit control easier and of ensuring that in the event of liquidation depositors shall obtain some dividend of their deposits. The main difficulty in connection with the legal minimum reserves has

been found to lie in the accurate definition of deposits, for deposits for reserve purposes are not those that appear in the balance sheets of the banks. This, however, is not of sufficient importance to merit discussion here, though it has aroused considerable attention in America. It is enough to say that demand deposits do not include balances due to other banks or cash items in course of collection.

The differentiation between the reserves of town and country banks is a relic of pre-federal reserve days and dates from the original National Bank Act. In so far as the banks in financial centres are no longer the legal reserve depositaries of country banks under federal law, it has lost much of its logic. It is now said to be justified by the fact that the deposits of city banks are the more active and therefore require higher reserves. This may be true, but, if so, it is illogical that the minimum reserves, recent temporary variations by the Board apart, should be lower than they were under the 1913 act (i.e. 18, 15 and 12 per cent., and 5 per cent. for time deposits), for the turnover of all deposits has increased since 1913. If the view is taken that the purpose of cash reserves is not to safeguard liquidity, but to contribute to the expenses of the reserve banks, the differentiation is justifiable on the ground that city banks are richer and enjoy greater benefits from membership. Informed opinion in the United States holds that the fixed ratios tend to be inequitable as between banks and that account should be taken of the genuine differences which exist in the character of the business in which different banks are concerned. In 1931 a committee of the federal reserve system on bank reserves suggested a ratio for all banks of 5 per cent. for total net deposits plus 50 per cent. of actual daily withdrawals, but never more than 15 per cent. of total deposits.[1] Nothing came of this suggestion. It should be noticed that the practical necessity of country banks holding bigger stores of till money than city banks tends to destroy their statutory reserve advantage.

[1] See p. 19.

The third characteristic of American cash reserves is the provision of a lower reserve against time deposits than against demand deposits. This is logical, but has raised certain problems. Here, again, there has been the difficulty of definition, but the chief problem has been the abuse involved in the acceptance of time deposits without enforcing notice of withdrawal. Time deposits have thus grown unduly in the past as compared with demand deposits, for with the advantage of smaller reserves commercial banks have been able to offer generous rates of interest on the former. To-day time deposits may not be withdrawn without thirty days' notice, and as will be seen, the Board may regulate rates of interest. As a result of these two factors abuse should be obviated.

Interest on deposits

No interest may be paid " by any device " on demand deposits placed with member banks since the passing of the 1933 act, except in the case of deposits payable abroad. The Board has the power, also under the act of 1933, to prescribe the rates payable on time deposits, according to conditions of deposit and locality. Under its Regulation Q, promulgated in August, 1933, the maximum standard rate was fixed at 3 per cent. This rate was reduced as from the 1st February, 1935, to 2½ per cent., and again as from the 1st January, 1936, with the result that rates are now fixed as follows :—

2½ per cent. for savings deposits (which are specially defined), postal savings deposits and deposits at six months' or more notice.

2 per cent. for time deposits at ninety days'—six months' notice.

1 per cent. for time deposits at less than ninety days'.

There is an exception that deposits made in accordance with a certificate of deposit or other contract lawfully entered into in good faith before the 1st December, 1935, may continue at the stipulated rate, if the bank is unable

to terminate the contract legally at its option, or without liability.

The prohibition of the payment of interest on demand deposits is in the interests of the banks. The offering of competitive rates of interest in order to attract deposits has led many a bank to adopt unsound practices, with the object of making such deposits pay. The new law achieves the advantages of greater safety and lower costs as far as the banks are concerned, and will discourage the flow of funds to money centres from banks in the interior at times of stock exchange activity, which in the past has been to the detriment of local industry. The same argument applies to the regulation of interest on time deposits.

It may also be noted here that the charges which member banks may collect from customers for the clearance of their cheques through federal reserve banks are fixed by law.

Dealings in securities

Restrictions on the type of business which member banks may transact must now be considered. Of these perhaps the most important is that on dealings in securities, which was imposed by the Banking Acts of 1933 and 1935. Member banks are only permitted to buy and sell securities without recourse, on the order and for the account of customers. They are also prohibited from underwriting new issues. The purpose of the former provision, which does not forbid the holding of securities purchased by banks for their own account before August, 1935, is to prevent member banks assuming the rôle of stock-jobbers. There is, therefore, a proviso that banks may purchase investment securities for their own account under such terms as the Comptroller of the Currency may prescribe, but in no case may they invest more than 10 per cent. of capital and surplus in the securities of any one obligor or maker. Investment securities include marketable bonds, notes, debentures and any evidence of indebtedness which the Comptroller may define as investment securities. The

above provisions do not apply to the obligations of the United States, of states, of the political subdivisions of states and of certain federal institutions (for example, the Federal Home Loan banks), which may be purchased without restriction.

No member bank may invest in the shares of a safe deposit company in an amount in excess of 15 per cent. of its paid-up and unimpaired capital and surplus.

The original National Bank Act did not permit national banks to buy investment securities, but the McFadden Act of 1927 did so by implication, in laying down that the Comptroller was to approve the marketability of securities bought. In fact, both national and state banks have long invested funds in securities. In very many cases, and particularly in 1928–29, the securities have been of a speculative nature and have been responsible for serious loss. Some banks have also in the past entered the market to support securities in which they were interested. The efforts which have been made to control bank speculation by "moral suasion" are described later. It is sufficient here to note that until 1933 there was little effective regulation of bank investment operations, except as regards a bank purchasing its own shares.

Acting on the authority given him by the Federal Reserve Act as amended, the Comptroller of the Currency issued regulations in February, 1936, to govern the purchase of securities by banks for investment purposes. These are extremely technical and minute, but the gist of them is as follows. Member banks may not buy securities which are in default as to interest or principal, convertible into stock at the option of the issuer, or distinctly or predominantly speculative or of inferior character. Bonds which are purchased above par must be regularly written down to their par value before they mature. Further, under his right to define "marketability", the Comptroller requires that an issue should be big enough to make marketability possible, should have been publicly distributed and should be registered under the Securities

Exchange Act of 1934 (which requires the registration of all securities dealt in on national stock exchanges). There are also regulations as to purchases on repurchase agreement.

These provisions of the Comptroller's Regulation, and that of the Federal Reserve Act which prohibits member banks from underwriting, should do much to reduce in the future the undesirable activities in which some of the banks have indulged in the past. The illiquidity of so many banks during the period 1929–33 was in large part due to the fact that not only did investment portfolios increase as compared with 1921,[1] but also the proportion of securities in them other than those of railways, public utilities, states and the government rose from 39 to 49 per cent. (and even railway and public utility paper has not been particularly marketable). As regards underwriting, it is said to have been by no means infrequent for a group of business men to found a bank to underwrite and hold the issues of the commercial businesses in which they were interested. In this connection the restriction on the holding of the securities of any one maker or obligor may also be expected to be salutary.

Loans on stock or bond collateral

Under the Banking Act of 1933 the Board has the power to fix from time to time for each federal reserve district the percentage of each individual bank's capital and surplus which may be represented by loans secured by stock or bond collateral. Such percentages are subject to change at ten days' notice. No such loan, however, may be made to any one person in an amount in excess of 10 per cent. of any bank's unimpaired capital and surplus. It is " the duty of the Board to establish such percentages with a view to preventing the undue use of bank loans for the speculative carrying of securities ". The Board

[1] Since 1933 investments account for an even greater proportion of bank assets, owing to the lack of other means of employing funds. In 1929 investments amounted to 28 per cent., in June, 1936, to 60 per cent. of the total assets of all banks. Of securities held in 1936, however, about two-thirds were direct obligations of the federal government.

"has the power to direct any member bank to refrain from further increase of its loans secured by stock or bond collateral for any period up to one year, under penalty of suspension of all rediscount facilities at federal reserve banks". It is worth noting that while the total loans of national banks increased between 1922 and 1930 by 50 per cent., those of them which were made against securities increased by over 100 per cent. About 25 per cent. of the loans of member banks in December, 1936, were covered by investment securities. Loans to brokers constituted a further 10 per cent. of loans.

The act of 1933 also prohibits member banks from making loans, as agents for any non-banking persons or bodies, to security dealers or brokers. After the crisis of 1929 it was found that many individuals and companies had lent money to the call market through the banks, encouraged by the high rates ruling there. Between early 1927 and October, 1929, these loans rose from $700 millions to about $3000 millions. The latter is a huge figure, when it is recalled that the total of loans on securities by member banks was only about $8000 millions in October, 1929; i.e. loans from outside sources amounted to over a third of those made by banks. When the crisis came this money was withdrawn and the banking system had to bridge the gap. Members of the New York Clearing House had already in 1930 agreed to discontinue the practice, but it is now forbidden by law, and "loans for others" thus pass from the field of controversy.

State member banks must conform to the rules which prohibit national banks lending against or purchasing their own stock. It will be noticed that there is no prohibition of lending on the stock of other banks, as there is in Canada,—where experience shows that the provision is, in fact, less necessary.

The Board of Governors of the reserve system has also been given, under the Securities Exchange Act, 1934, important powers in connection with loans by banks for the purpose of purchasing or carrying securities. In its

Regulation U, which came into force in May, 1936, it fixed a margin requirement of 55 per cent.[1] on loans for the purchase of securities registered on national security exchanges (except in the case of certain loans to brokers and dealers). In other words, a loan by any bank to a customer for the purchase of securities may not exceed 45 per cent. of the value of the securities thus purchased and pledged with the bank ; the customer has to find 55 per cent. of the purchase price himself. The Board has the right under the same act to fix margins for loans by brokers and it issued a regulation in this connection soon after the passage of the act. The more recent regulation has been made necessary by the fact that the banks compete with brokers in making such loans, and had again begun to do so on a scale that would have made it inequitable not to put the two on the same footing. It should be added that the regulation does not apply to loans secured by bonds or made for the purpose of carrying bonds.

The advantage of the device of margin requirements is that it provides an instrument for controlling the demand for credit from speculators in the stock market, without restricting the supply available for other borrowers or raising the price which other borrowers have to pay for it.

Limitation on rediscount

Federal reserve banks have the power to rediscount for their member banks certain types of "eligible paper":—notes, drafts and bills of exchange arising out of *bona fide* commercial transactions and endorsed by a member bank ; notes, drafts and bills similarly endorsed and issued for the purpose of carrying or trading in United States

[1] The margin was reduced, while this chapter was in the printers' hands, from 55 per cent. to 40 per cent. as from the 1st November, 1937, in view of the stock exchange collapse of October, 1937. Experience has shown that when security prices are falling, the existence of a high margin intensifies the bear tendency of the market, by discouraging buyers. At the same time a margin requirement of 50 per cent. was imposed on short sales with the aim of discouraging sellers. This innovation of changing statutory margin requirements introduces new possibilities of control by the Board of Governors.

government bonds and notes (such instruments in all the above cases not to have more than ninety days to run); sight drafts covering domestic shipments or exports of staple commodities and secured by documents of title; ninety days (or, if drawn for agricultural purposes, up to six months) bankers' acceptances of member banks. Instruments drawn for the purpose of trading in securities are expressly excluded.

No federal reserve bank, however, may rediscount for a state member bank the notes, drafts or bills of exchange of any one borrower who owes that bank a greater sum than he would be permitted to borrow from it were it a national bank. This refers to the 10 per cent. limitation (see p. 389), and in effect imposes on state member banks the statutory restriction on national bank lending, by withholding from state member banks which do not observe it the privilege of rediscount.

Advances by federal reserve banks to member banks

Federal reserve banks are authorised to make advances to member banks against certain types of eligible security for periods of up to fifteen days. Under a recent amendment, however, such advances are to be deemed to be immediately due for repayment, if any member bank, during the life of such an advance, and *despite an official warning* of the reserve bank or the Board, increases its outstanding loans against collateral in the form of stocks, bonds, debentures or other such obligations, or loans to members of a stock exchange, investment house or dealer in securities, for the purchase and/or carrying of securities. The penalty is loss of the right to borrow at the reserve bank for a period to be determined by the Board. A more detailed discussion on rediscounts for and advances to member banks is found on pp. 336-9 and 446-51.

Affiliates

It is not possible to define an affiliate in a few words, for the Federal Reserve Board in 1931 classified nineteen

different kinds of bank affiliates, on the basis of their functions and the way in which they were controlled or exercised control. There were at that time 770 affiliates in the country. It is possible, however, to distinguish two main kinds of affiliate in American banking in the nineteen-twenties,—holding company affiliates and security affiliates, the former controlling, the latter controlled by, the banks.

A holding company affiliate is a bank or a mere holding company, which controls a group of banks. Such companies owe their rise to the restrictions on branch banking. They developed mainly in the period 1926–30, and in the latter year there were 2229 banks owned by 287 groups or chains; of these 1217 were non-member banks, but about 85 per cent. of the resources thus controlled were those of member banks. The danger of group banking, as it is called, is the interdependence of banks jointly controlled and the, in many cases, disastrous effects of the failure of one on the stability of the others. The holding company frequently had behind it nothing but the shares it owned in other banks; the double liability of stockholders provided for in the National Bank Act and in most state laws thus practically disappeared. Further, groups are said in one or two cases to have been so powerful that they gained control of the local federal reserve bank. It will be appreciated that banks in a group might be state or national banks, member or non-member banks, subject to examination by different authorities at different times; thus arose the abuse of shifting bad assets from one bank to another just before the examination of any particular member of the group.

With this state of affairs in view, the acts of 1933 and 1935 have attempted to control the activities of holding companies by restricting their voting rights on the common stock they own. Holding companies may now only vote stock held in member banks under permit from the Board. Permits are only granted to such holding companies as agree to undergo examinations at the same time as

the member banks whose stock they hold,—and to pay for the examinations ; to disclose fully their relations with such member banks ; to permit other banks also controlled by the holding company to be examined ; and to furnish consolidated statements of condition where required. Again, by June, 1938, holding companies must purchase and hold readily marketable assets other than bank stock in an amount not less than 12 per cent. of the aggregate par value of all bank stocks controlled by them. This must be increased by 2 per cent. each year, whether profits are earned or not, until the value of such assets amounts to 25 per cent. Whenever in any year their earnings exceed 6 per cent., the whole of the surplus must be added.

Holding companies whose shareholders are in a position to incur double liability are only required after 1938 to invest in readily marketable assets their net earnings over and above 6 per cent. until they own an amount equal to at least 12 per cent. of their holdings of stock in subsidiaries.

In applying for voting permits holding companies are bound to show that they do not own, control or hold any interest in security companies engaged in the issue, flotation, underwriting, sale or distribution of stocks, bonds, debentures, notes or other securities ; to agree not to acquire control, ownership or interest in such companies ; or, if at the time of application they have some such interest, to divest themselves of it within five years. They must also agree to declare dividends only out of actual net earnings. There seems little doubt but that these provisions will enable the authorities to keep track of the tortuous trends which are associated with holding company finance, and to furnish bank depositors with valuable safeguards.

A security affiliate is, or rather was, a state-chartered company controlled (through the ownership of stock, a common directorate or some other means) by a bank, and authorised to engage in one or all of a number of financial transactions, such as the wholesale purchase and retail

distribution of securities ; the holding of securities for speculative purposes or to gain control of business undertakings ; the holding of real estate ; the support of the market in a bank's own stock ; underwriting ; and the taking-over, for purpose of realisation, of the frozen or doubtful investments and loans of a parent bank. The first such affiliate was formed in 1908, but after the War the movement spread and some banks came to own groups of affiliates, the finances of which were inextricably interlocked. By 1930 bank affiliates were sponsoring nearly 55 per cent. of all new security issues.

It can be seen that through this medium the banks were able to carry on business which is not properly allied to commercial banking, under cover of secrecy and with great danger to their own stability and soundness. The wholesale and excessive underwriting of securities by these companies contributed much to the stock exchange speculation of the years 1928–29, and when the tide turned they were left with big unsold holdings of worthless shares. They were, of course, large borrowers at their parent banks, and this nullified the advantage which the banks had in being able to pass over their slow loans to them. In 1930 the Bank of the United States, with 59 affiliates, collapsed, and it was largely the public feeling aroused by this event which led in 1933 to the suppression of security affiliates.

No member bank may now be affiliated to or control in any way any corporation or association engaged principally in the issue, flotation, underwriting, sale or distribution of stocks, bonds, debentures or other securities. Security companies are also prohibited from receiving deposits repayable on demand, except with the permission of the Board. The 1933 act even went as far as to prohibit a member bank from acting as correspondent of a securities company without a permit, but this provision was repealed in 1935. It has already been noticed that no member bank director, officer or employee may serve in such a company.

The Banking Act of 1933 therefore completely divorced

the businesses of deposit and investment banking. There has been a feeling, especially among the bigger and better New York banks, that this step was unduly harsh ; that security affiliates had performed a useful purpose and that restriction and supervision, such as is provided for holding company affiliates, would have been sufficient. Taking all in all, however, the change must be considered to be a healthy one.

There now remain in the United States holding company affiliates and a number of other institutions, not controlling or controlled by, but allied with commercial banks ; some of them are themselves commercial banks, others are safe-deposit companies, banks engaged in foreign business, etc. All institutions affiliated in any way to a member bank are now, under section 9 of the Federal Reserve Act, put under obligation to furnish reports to the federal authorities and to submit to examinations. The Banking Act of 1935 has amended and added to this provision of the 1933 act, and as a result it is now laid down that no certificate evidencing ownership of the stock of a member bank shall bear any statement purporting to represent the stock of any other corporation (company), except a member bank or a corporation engaged on 16th June, 1934, in holding the premises of the first bank. Nor may the ownership, sale or transfer of member bank stock be in any way conditioned by that of the stock of such other corporations. Banks and their affiliates were frequently subject to common ownership, one share certificate being issued for the two or more institutions. The new provision does not destroy affiliations, but it restricts a rather undesirable practice. A loophole may, however, be left by a proviso in the section to the effect that the ownership, sale or transfer of stock in another corporation *may* be conditioned by that of the stock of a member bank.

Section 23A of the Federal Reserve Act imposes still more restrictions on affiliates. No member bank may (a) make loans to, extend credits to or buy securities under repurchase agreement from any affiliate ; (b) invest

any of its funds in the capital or obligations of an affiliate; (c) accept such obligations as collateral for advances:— in excess of 10 per cent. of its capital and surplus. Where a bank has more than one affiliate, it may dispose of up to a total of 20 per cent. of its capital and surplus in this way.

A loan to an affiliate within the above limits is required to be protected by security having a market value of at least 20 per cent. more than the amount of the loan, or 10 per cent. in the case of security in the form of obligations of states and their political subdivisions. No surplus value is necessary in the case of loans against United States government securities and other eligible paper. It may be added that loans to the directors and officers of affiliates, if for the benefit of affiliates, are reckoned as loans to affiliates. With certain exceptions, which need not be closely examined here, all affiliates are affected by this section of the law, i.e. section 23A. Examples of the exceptions are affiliates engaged in foreign banking, in conducting a safe-deposit business and in holding government securities.

Dealings with non-member banks

No member bank may deposit with any non-member bank a sum in excess of 10 per cent. of its own capital and surplus. Nor may it rediscount paper with a federal reserve bank on behalf of a non-member bank, except with permission of the Board. The purpose of this is to prevent banks which do not contribute to the expenses of the reserve system from enjoying the benefits which flow from it.

Acceptances by member banks

Any member bank may, under the original Federal Reserve Act, as slightly amended during the War, accept drafts or bills of not more than six months' usance against transactions involving the movement of goods, provided that shipping documents are attached at the time of acceptance, or that the bills are secured by some document of

title. Such acceptances may not exceed 50 per cent. of the bank's paid-up and unimpaired capital and surplus; unless permission has been gained from the Board; even in the latter case they may never exceed 100 per cent. The aggregate of acceptances arising out of domestic transactions may never exceed 50 per cent. Bills not secured by attached documents or some other security arising out of the transactions in question (i.e. clean bills) may not be accepted for any one customer in excess of 10 per cent. of capital and surplus.

A member bank may not put up dollars for any one foreign bank, by accepting its bills, in excess of 10 per cent. of its paid-up and unimpaired capital and surplus, unless the draft is accompanied by documents of title. At no time may the total of such acceptances exceed 50 per cent. of capital and surplus.

Reports and examinations

Each member bank must send at least three reports of condition annually on a prescribed form to its federal reserve bank and to the Board, on demand. These are accompanied by the condition reports of its affiliates other than member banks for the same days, and must be such as to disclose fully the relations between the bank and its affiliates. Additional reports of affiliates may also be required.

The Federal Reserve Act requires the Comptroller of the Currency to appoint examiners to examine each member bank at least twice a year, and oftener, if necessary; but in the case of state member banks the Board may authorise examinations by state authorities to be accepted. The affiliates of state member banks are liable to examination, as well as those of national banks.

In addition, every federal reserve bank may, subject to the approval of the Board, make a special examination of any bank in its district; and is under obligation at all times to supply to the Board information about such banks. Examination expenses are in all cases borne by the bank examined.

Loans and gratuities to bank examiners by member banks, their officers, directors and employees are not permitted. Nor is employment of any kind to be given to them while they remain examiners.

Emergency Banking Act, 1933

This act, passed at the time of the banking crisis of March, 1933, and later amended, gives the President of the United States the right, in any period of national emergency proclaimed by himself, to investigate, prohibit or regulate transactions in foreign exchange, transfers of credit between or payment by banking institutions : and to regulate, limit and restrict, through the Secretary of the Treasury, any banking business of a member bank. It will thus be seen that, although the degree of control exercised over member banks is very considerable even in normal times, in abnormal times it is absolute.

The act also contains emergency provisions for the appointment of bank conservators under the Comptroller, who is armed with extensive powers for this purpose.

Federal reserve control

Control of member banks of the federal reserve system is divided between the Board of Governors and the district boards of the twelve reserve banks. The division of power has led to difficulties and misunderstandings at times, especially in the field of credit control. An examination of this subject, however, is hardly germane to our present purpose, for from the point of view of member banks it matters little by which authority they are controlled.

While the twelve reserve banks have certain functions of credit control and are in a general way responsible to the Board for keeping themselves and the Board informed of developments in their respective districts, supervisory and discretionary powers are placed mainly in the hands of the Board. It may be useful to summarise briefly some of the most important of these powers.

The chief supervisory powers of the Board are as follows :—

Admission to membership and expulsion from membership.
Examination and the receipt of reports of member banks and affiliates.
Fixing of percentage of each bank's capital and surplus that may be lent on stock or bond collateral.
Suspension of rediscount facilities in certain cases.
Fixing of margin requirements for loans on securities.
Permission to holding companies to vote bank stock in banks they control.
Grant of trust powers to national banks.

To these powers may be added a further important series which imply the exercise of discretion on the part of the Board :—

To reduce capital requirements for small insured banks.
To permit a member bank officer or director to serve in another bank.
To remove officers and directors of state member banks.
To control the opening of new branches by state member banks.
To vary restrictions on acceptances by member banks in special cases.
To vary the law concerning member bank deposits in non-member banks in certain cases.
To grant permission for the investment in premises by state member banks of more than their capital.

These are all matters in which the Board may vary the application of the law in special circumstances, and are extremely valuable in so far as they are conducive to flexibility.

A third series of powers may be termed regulatory :—

Regulation of charges for the collection and payment of cheques.

Definition of paper eligible for discount at the federal reserve banks.

Review and determination of rates at which federal reserve banks make loans to member banks on their promissory notes, or rediscount their eligible paper.

Determination of rates of interest on time deposits.

Raising and lowering of cash reserve ratios.

These powers are more intimately concerned with credit control, which is to receive closer consideration on pp. 435-46.

The media through which the Board exercises its powers are known as Regulations, which are lettered at the present time from A to U. These Regulations are issued in accordance with authority conferred, in nearly all cases, by the Federal Reserve Act, and are revised from time to time. The Regulations of the Board may be compared with executive orders issued in some countries to amplify general principles set out in the law itself. Their function is to give content to such expressions of principle. It will be seen that they deal in most cases with matters already referred to in this section, but it appears to be useful to present a complete list of them and of the dates on which they became effective or were last amended :—

(A) Rediscounts by federal reserve banks (amended 1.8.30).

(B) Open-market purchases of bills of exchange, etc., by federal reserve banks (amended 3.1.28).

(C) Acceptances of drafts and bills of exchange by member banks (amended 3.1.28).

(D) Reserve requirements of member banks (amended 1.1.36, supplemented 30.1.37).

(E) Purchase of warrants by federal reserve banks (amended 3.1.28).

(F) Trust powers of national banks (revised 1.6.36).
(G) Rediscount of notes secured by adjusted service certificates (revised 10.8.32).
(H) Membership of state banking institutions in the federal reserve system (revised 1.1.36).
(I) Increase or decrease of capital stock of federal reserve banks (revised 1.1.36).
(J) Cheques—clearing and collection (amended 1.9.30).
(K) Titles of foreign banking corporations.
(L) Interlocking directorates under the Clayton Act (revised 4.1.36).
(M) Open-market operations (effective 10.8.33).[1]
(N) Relations with foreign banks and bankers (effective 10.8.33).
(O) Loans to executive officers of member banks (effective 1.1.36).
(P) Voting permits for holding company affiliates (revised 1.1.36).
(Q) Interest paid on deposits by member banks (revised 1.1.36, effective 1.1.37).
(R) Relationships of member banks with dealers in securities (revised 4.1.36).
(S) Loans by federal reserve banks to industrial or commercial businesses (effective 26.6.34).
(T) Extension and maintenance of credit by brokers, dealers and members of national securities exchanges (amended 1.11.37).
(U) Loans by banks for purchasing or carrying stocks (amended 1.11.37).

In addition to issuing Regulations, the Board of Governors is entrusted also with the task of interpreting and issuing rulings on the Federal Reserve Act. Such rulings are published month by month in the *Federal Reserve Bulletin* and there are usually about fifty of them issued each year, in addition to certain other statements by the

[1] Superseded by a Regulation of the Federal Open-Market Committee, March, 1936.

federal reserve authorities on matters of law and practice.

What, in brief, can be said to be the effect of the reserve system of banking control, and what are its most significant aspects ?

Firstly, the privileges of membership are of different value to different banks, but to most they are great, for, as will be seen, after 1941 the privilege of deposit insurance will depend on membership ; the authorities have the power to admit to and expel from membership, and this is no mean weapon. Secondly, they have, under recent legislation, power to remove directors and officers. Thirdly, they derive considerable strength from being the lenders of last resort, from controlling the cash ratio of member banks and from open-market policy. They have the right to examine and demand reports. They have complete control over the opening of new branches, and over the rates of interest paid on deposits. They have some control over the volume of loans on securities, and over the affiliates of member banks. The law itself lays down stringent rules as to capital, directors, reserves, premises, dealings in securities, security affiliates and acceptances. And finally, in time of emergency the President of the United States is authorised to regulate any part of a member bank's business.

Armed with these powers, the federal authorities should be in a strong position to exercise a beneficial control over member banks, subject to certain qualifications to be mentioned in the concluding section of this chapter.

Credit Control

In addition to the statutory regulations which govern their constitution and operations, member banks of the federal reserve system are subject to the continuous control and supervision of the reserve banks and Board. Reports and examinations have been mentioned above and will be discussed more fully later. At the moment we are to examine briefly the control which the reserve

system exercises over the total volume of credit extended by its members.

It has already been noticed that in the United States the minimum reserves of member banks are fixed by law. The reserves of individual banks at times sink below the legal minimum, but only temporarily. On the other hand, at a time of business depression all member banks may build up excess reserves, though of course involuntarily, for no interest is paid on deposits at the reserve banks. But in normal times the volume of member bank credit is a multiple of member bank reserves, and in so far as the central banks are able to control these, they control the volume of member bank deposits. Member banks are naturally never all in the same position as regards reserves, and it is not possible without further data than the size of its reserve to say what effect federal reserve action will have on the deposits of any individual bank. A bank with big reserves to spare can afford to see them reduced without curtailing its loans ; a bank on the margin which suffers a loss of reserves will be forced to reduce its deposits (or rather its other assets) into line with the reserves it retains. In the United States, as in this country, there are two main instruments of control, bank-rate or rediscount-rate policy and open-market policy. These must now be considered in turn.

Rediscount rate

The traditional method of controlling credit is by the manipulation of rediscount rates, a rise in the rates having the effect of contracting credit, a fall leading to expansion. In England bank rate achieves this result mainly through the convention that the various market rates move up and down with it (see p. 242); the terms on which credit is offered are thus influenced and the demand for credit reacts accordingly. In the United States cause and effect are not quite the same.

There is in the American money markets a whole complex of rates, of which the most important are as follows.

Firstly, there are the rates which member banks charge on loans to private and business customers, and those on loans to the stock exchanges (call money). The former are usually high and inelastic, though in some states there are legal maxima; the latter rates vary considerably and, unlike the rate for money lent to the discount houses and stock exchange in London, may rise above the rate for advances to ordinary customers. Secondly, there are the open-market discount rates for the commercial paper of business and industrial firms, and for bankers' acceptances. Finally, there are the three sets of federal reserve rates :—the rediscount rates at which the 12 federal reserve banks will rediscount the eligible paper of their members; the rates at which they will make fifteen-day advances to member banks on their promissory notes collateralled by eligible paper (normally ½ per cent. higher than the rediscount rate); and the rates at which federal reserve banks hold themselves open to buy bankers' acceptances offered to them by brokers in the open market (which is seldom much above the brokers' buying rate, for federal reserve policy has aimed at creating a bill market).

As the volume of member bank credit depends primarily on the size of member bank reserves, and member banks are free to build these up by rediscounting eligible paper with the federal reserve banks, clearly the important rates from the point of view of control are those for federal reserve rediscounts and advances, taken in comparison with member bank customer and call money rates. If the former fall as compared with the latter, borrowing at a reserve bank is encouraged and credit expands; if they rise—and if they rise much they are said to become penal—the effect is deflationary. The relation between member bank rates and rediscount rate is not nearly as constant as in London, customer rates being usually high and inflexible. Thus a rise in the rediscount rate frequently achieves its object, where it does achieve it, not by making the terms of lending unacceptable to customers of the commercial banks, but

by taking the profit out of rediscounting and thus reducing the reserves of the banks themselves.

Federal reserve authorities have never been in agreement as to whether rediscount rates should be penal or indeed as to whether in fact they are penal. Subject to the consent of the Board, each reserve bank fixes its own rediscount rate and there is no one rate prevailing at any one time in all districts. The federal reserve banks of New York and Chicago have usually favoured penalty rates ; the Board at first favoured them in principle, but later under stress of popular opinion were against their imposition. It should be noticed that the rediscount rate need not be above member bank rates in order to penalise, for a member bank incurs certain expenses in discounting and rediscounting, and it has been stated that a banker getting 6 per cent. from his customer cannot make a profit on rediscounting at 5 per cent. Looking at it from another point of view, W. R. Burgess [1] points out that if a banker's acceptance charge is 1 per cent., he should charge this for adding his name as endorser to his customers' one-name paper when he rediscounts it. Thus with customer rate at 5 per cent. and rediscount rate at 4 per cent. there is no inducement to borrow at a reserve bank, for he requires 1 per cent. to compensate him for that part of the risk which he retains.

There have been practical difficulties in the way of imposing rates that might be penal. Firstly, member bank rates have sometimes been as high as 12 per cent. It would have been impracticable to raise rediscount rate to this limit. Again, member bank rates vary as between bank and bank in the same reserve district. In the country parts of the New York district such rates may be twice as high as they are in the metropolis. Thus what would penalise one bank might encourage another to rediscount. Thirdly, a rate which might penalise loans to industrial and private customers might not affect loans at call, and *vice versa*. Eligible paper is

[1] *Reserve Banks and the Money Market*, 2nd edition, 1936, p. 227.

presented for rediscount at a given rate,—and since June, 1921, all eligible paper has fetched the same rate,—but there is no knowing to what use the proceeds are put. This also raises the practical point: on what rate is the rediscount rate to be based? On the average of rates charged by member banks, on the return on bills discounted, on call money rates, on customer rates, on the rates which member banks earn on their investments in securities (for the alternative to rediscounting is often to sell investments)? Clearly the answer must differ under different market conditions and above all in different parts of the country.

Fifthly, there has always been in the United States a feeling that trade and industry must be accommodated at all costs, and an increase in the rediscount rate, when stock exchange values are rising, has invariably been criticised on the ground that the legitimate needs of business are not being considered. A sixth difficulty is that, whatever the point to which rediscount rate may be raised, banking convention requires that a reserve bank should always passively buy at a moderate rate bankers' acceptances offered to it in the market. This may well stultify rediscount policy, as it did in 1929, for the channels in which money flows cannot be kept separate. A seventh weakness is that, while many banks are continuously borrowing at reserve banks, the majority are not. A high rediscount rate can only curb the activities of banks which are in debt or just out of debt to the reserve banks. Lastly, the politicians have always been opposed to a high rediscount rate, and their view has greatly swayed the Board, which has to admit part responsibility when rates are raised.

The considered opinion of most of those who have watched American money markets since the War is that the rediscount rate has not on the whole been penal, and that its effect, other than psychological, as an instrument of control, has been small.

Open-market policy

By section 14 of the Federal Reserve Act federal reserve banks may, under the rules and regulations prescribed by the Board of Governors, purchase and sell in the open market, at home or abroad, cable transfers; bankers' acceptances; bills of exchange with or without a member bank's endorsement but of the character and maturity to make them eligible for rediscount at a reserve bank; bonds and notes of the United States; bonds and notes of certain government corporations and banks and of states and their subdivisions, maturing within six months. The term "open-market operations", however, is applied in a more restricted sense than might be judged from this section, for it refers only to sales or purchases by the reserve banks of government securities—transactions in which they take the initiative. Of the other instruments mentioned above by far the most important are bankers' acceptances, which the reserve banks in practice buy, but do not sell. Such purchases, however, are never an instrument of control, but are made, as mentioned above, in order to foster the growth of a discount market.

The effect of an open-market purchase of securities by a reserve bank is to put member banks in funds and thus to decrease their borrowings at that reserve bank, or to increase their balances with it. The effect of a sale is to reduce member bank balances at the reserve banks, and thus to discourage lending by member banks.

Although the original reserve act gave the reserve banks power to buy and sell in the open market, such operations were not employed in the early years as a weapon of credit control, but at the convenience of the different reserve banks, as and when they wished to acquire or relieve themselves of government securities as earning assets. Thus in 1922 the reserve banks between them bought $400 millions of government securities, because they had surplus funds to invest. It seems that it was at this time that the potency of such an operation as an instrument of control

was first realised. In 1923 a conference was held at which definite principles were first laid down. An Open-Market Investment Committee was formed, which functioned until it was superseded by an Open-Market Policy Conference in 1930. In 1933 this became the Federal Open-Market Committee, and, after a further reconstitution in 1935, now consists of the Board and five representatives of the reserve banks. It has complete centralised control of all open-market operations, and, as laid down originally in 1923, governs " the time, character and volume of all purchases and sales . . . with a view to accommodating commerce and business and with regard to their bearing upon the general credit situation of the country ".

There has never been complete agreement as to the part which open-market operations play in credit control. At one time they have been held to prepare the way for rediscount policy, i.e. a sale of securities is a preliminary to raising the rediscount rate. At another time sales have been said to reinforce a rise in the rate. It has also been claimed that they are a substitute for raising the rate. In practice, however, they have been found to be a weak substitute, for as soon as the reserve authorities reduced member bank balances by selling securities, member banks rediscounted heavily with the reserve banks. Governor Harding stated in 1929 that the rediscounts had in some cases been obtained on notes collateralled by the very securities previously sold by the reserve banks. Even accompanied by an increased rediscount rate, however, open-market sales of securities may well be nullified by the convention that the reserve banks must buy all bankers' acceptances offered to them in the open market, at a rate round about the market rate. If this convention were discarded, the reserve banks would in most cases be in a strong position to control an expansion of member bank credit.

With regard to control in the opposite direction, recent history has shown that open-market policy is not, at times, a particularly strong force in creating an expansion of

credit. Between 24th February and 10th August, 1932, the reserve banks increased their holding of government securities from $741 millions to $1851 millions. The result was merely that member banks built up excess reserves at the reserve banks. There was no reduction in member bank lending rates.

Other factors must also be borne in mind in assessing open-market policy as an instrument of control. Firstly, sales can only be successful if there is a reasonable market in government securities. There must always be some sort of limit to the volume of government securities the market can absorb. At a time of speculation in equities, when the Federal Open-Market Committee might wish to sell government bonds, they would probably find few buyers. Secondly, when member banks have large excess reserves it requires a very large sale of government securities to be effective. In 1935–37 excess reserves have been so great that open-market sales could not have achieved any important success, if a dangerous expansion of member bank credit had set in. Again, in order to sell securities the reserve banks must first have bought. It is therefore the task of the reserve banks, seeing ahead a time when it may be necessary to curb credit expansion, to provide themselves with big portfolios of securities. But this can only be done by increasing current expansion and hastening the ill which they have later to cure.

As regards purchases, there must clearly be some limit to the proportion of their assets which the reserve banks can invest in U.S. government securities. Attempts have been made to calculate this and the limit would appear to be about 40 per cent. Secondly, there were at one time doubts as to whether there existed government securities available for purchase sufficient for reserve policy to be effective. To-day, however, there is no fear on this score, owing to the large increase in the volume of government securities in connection with New Deal programmes.

There are two other complications. Care has to be taken that federal reserve policy does not embarrass the

Treasury. The size of the operations carried out by the federal reserve banks cannot at times but have a big influence on the value of government securities.[1] The second complication is gold movements, which may easily destroy the effect of security operations. In 1928–29, when it was the duty of the reserve banks to put the brake on expansion, that same expansion was responsible for large gold inflows from abroad.

Open-market policy was employed in Great Britain, prior to 1931, mainly to neutralise small inflows or outflows of gold. Where it has been limited to moderate ends in the United States, e.g. to meet seasonal fluctuations, it is said to have met with the same success as in Great Britain. Larger operations have been less successful, because they have to a great extent been experimental and because they have not been carried out in the full measure which circumstances required. The distinction might be expressed in another way. Where the problem has been to adapt money conditions to the requirements of business, operations in the open market have been successful. Where, however, their object has been to impose on the country a credit policy not in keeping with current market tendencies, to adapt business activity to monetary conditions, they have not been attended with the same success. The federal reserve system has not yet learned to flatten out the trade cycle. Nor has there always been consistency of policy. When gold has flowed in or out, policy has been divided between (1) offsetting this and (2) reinforcing by open-market operations the effect of the gold inflows or outflows on the credit structure. For example, securities were purchased in 1927 in face of a gold inflow because the gold would otherwise have been sterilised and orthodox theory requires that a gold inflow shall be followed by credit expansion: securities were also purchased in 1928 in face of a gold outflow, to offset any deflationary tendency

[1] The reserve authorities were accused in 1935 of purchasing government securities in order to keep their value up.

that might develop. It is still impossible to say what, in many given sets of circumstances, federal reserve open-market policy will be.

Changing reserve ratios

The power of the Board of Governors to change reserve ratios may, in the view of some authorities, develop into its most important instrument of credit control. Up to the summer of 1937, however, the excess reserves of member banks have been so great that it has been possible to double the statutory ratio without restricting credit. One might say, therefore, that up to the present the Board has done nothing more than make reserve ratios effective (as the Bank of England might make bank rate effective by bringing it into line with market conditions). The value of its action lies, at the moment, in having so reduced excess reserves[1] that it will be possible to affect the credit base by the normal instruments of credit policy—rediscount rate and open-market operations,—when the time is ripe. Raising reserve ratios has thus still to meet the test of being employed in an emergency.

In a set of circumstances such as those which existed in the years 1928–29 the procedure would probably consist of a gradual raising of ratios by a series of small percentages. This policy would have much the same cumulative effect as a series of open-market sales. The reserve authorities would, of course, lay themselves open to much criticism, especially if they raised ratios above the existing percentages. Open-market policy may have the same effect,[2] but cause and result are not there so directly and intimately connected. There would, of course, also be real cases of individual hardship, as there are when open-market operations are carried out.

[1] $3000 millions of excess reserves had been eliminated up to May, 1937, by doubling reserve ratios.

[2] By sending existing percentages below the statutory ratios.

Perhaps one of the most useful ends to be served by the manipulation of statutory reserve ratios is the preservation of liquidity at a time of crisis by the reduction of ratios. Had the federal reserve banks possessed the power to release a proportion of the liquid funds held by them for their member banks in March and April, 1933, the catastrophe of those months might have been avoided. It must, however, be remembered that ratios may not even now be reduced below the statutory 13, 10 and 7 per cent.

It is interesting to note that the device of changing reserve ratios has now been introduced into New Zealand.

The results of credit control

It cannot be said that credit control by the federal reserve authorities has been particularly successful. In 1929 they failed to prevent a crisis of inflation: four years later they were equally powerless to prevent a deflationary crisis. In both cases the collapse was due to failure, during the two or three preceding years, to stay a tendency which was bound to end in trouble. The authorities have been too slow, have lacked in courage to pursue a strong policy, and, above all, have differed too often among themselves as to what policy should be. Just as the commercial banks belong to forty-nine different systems, so it may be said that the federal reserve consists of thirteen or fourteen authorities, each with its own ideas on policy.

Being freed for long periods from preoccupation with gold reserves, the central authorities have been able to give their attention to other considerations. Among a number of elements influencing policy named by Professor T. E. Gregory[1] in 1930 were: the provision of adequate accommodation for and encouragement to business; the indication of there being a speculative spirit abroad at any particular time; the international situation (in 1927 a cheap money policy was pursued to maintain foreign

[1] In a series of lectures before the Institute of Bankers.

markets for American agricultural products); the provision of a weapon, in the form of securities portfolios, for future use; the volume of reserve bank credit outstanding; the loan policy of member banks. In addition there has been mention of stabilising economic conditions, stabilising prices and stabilising money rates. When, in March, 1933, the reserve banks had to safeguard their gold reserves, they found themselves dealing with a problem which had never seriously engaged their attention before.

The effect of such vacillation at the fountain-head of credit cannot but have had a disturbing effect on member banks, which have had to carry on the ordinary business of banking under the control of authorities whose next step in any given set of circumstances could never be accurately gauged. The lending of money is a business which cannot be abruptly subjected to change and experiment.

In so far as there has been control of commercial bank credit it has been made possible by the wholesome convention, which has existed since 1913, that member banks should not in normal times be in debt to the reserve banks. This convention is in fact a relic of the days when country banks kept reserves with their city correspondents. Apart from this self-imposed restraint of the best banks, the reserve banks would have been much less successful than they have been, and the system would probably not have been workable. There have, however, always been certain banks which have not exercised this restraint, especially in times of credit expansion.

Moral Suasion

While bank rate and open-market policy have been the instruments for controlling the quantity of credit put at the disposal of member banks by the federal reserve banks, they are not designed to effect another form of control which has been of considerable importance

in American banking, — qualitative control. Theoretically, indeed, while it is the function of a central bank to control the quantity of member bank credit outstanding, it has no concern with the distribution of that credit. In the United States, however, where member banks are sometimes in debt to the reserve banks and where the pernicious use of bank credit for speculative purposes has been responsible for recurrent crises, the central authorities have, in varying degrees at different times and in different parts of the country, assumed the function of attempting to control the use to which federal reserve funds, obtained by loan or by the rediscount of eligible paper, are put.

It will be remembered that the types of paper eligible for rediscount with the federal reserve banks are closely limited. It was hoped that, by restricting the right of rediscount primarily to commercial, agricultural and industrial paper, and by expressly excluding paper issued or drawn to cover transactions in investment securities, credit would flow into the desired channels. It was clearly the aim of the creators of the system to prevent the speculative use of federal reserve funds. Experience, however, showed that the provisions of the act were not sufficient for this purpose, for funds acquired by the rediscount of eligible paper might quite easily be put to speculative use. It was thus that " moral suasion " came to be applied. There had, indeed, been during the War an effort on the part of the reserve authorities to ensure the flow of credit to " essential " industries as opposed to " non-essential " industries, but moral suasion proper is a post-War development.

Up to the passing of the Banking Acts of 1933 and 1935 the legal right of the reserve authorities to use discretion in extending credit to any individual bank, if the right sort of paper were offered, was doubtful. The part of the law invoked was section 4(8) of the Federal Reserve Act, in which federal reserve banks were required " to extend to each member bank such discounts, advancements, and

accommodations as may be safely and reasonably made with due regard for the claims and demands of other member banks ". It was argued that, in extending credit for a purpose not provided for in the act, reserve banks would be limiting the amount available to other member banks for legitimate purposes. To the argument that the act required reserve banks to administer their affairs " fairly and impartially and without discrimination in favor of or against any member bank ", it was fair to reply that equal treatment, when other things were not equal, could not be justified. When, however, all banks were lending for speculative purposes, the interpretation mentioned above was a little strained. The federal reserve bank of New York, in fact, refused on a number of occasions to apply moral suasion by bringing pressure to bear on its member banks with loans in the call market; (moral suasion was always more popular in the south and west than in the big money centres). It insisted that the function of the reserve authorities was quantitative, not qualitative, control, and that rediscount-rate policy was the appropriate instrument. It was, perhaps, natural that while the Board did not wish to make itself responsible for a severe — and unpopular — bank-rate policy, which the reserve banks have usually advocated in times of expansion, it pinned much faith to moral suasion, which the reserve banks had the hardly pleasant duty of imposing. The New York reserve bank was quite willing to apply discretion in the case of one bank borrowing excessively, but not when all were over-borrowing. It has been seen, however, that to attempt to accommodate trade and industry and at the same time restrict stock exchange speculation, by rate policy alone, is impossible. Money finds its own level, and there has therefore been much to be said for the position taken by the Federal Reserve Board. The Board has felt, too, that in raising the rediscount rate, e.g., in February, 1929, it would have implied that member banks which could pay the price were free to borrow for any purpose.

The Board contented itself in 1929 by announcing that member banks using reserve facilities to make or maintain speculative loans were beyond their rights ; it is doubtful, however, whether this statement was good in law. Federal reserve banks are not bound to rediscount all eligible paper presented to them. They might conceivably not have the funds to do it, for the amount of eligible paper in existence always exceeds the resources of the reserve banks. But it is doubtful how far they had the right to refuse accommodation, except where one member bank was taking more than its proper share of the reserve funds of its district.

Apart from the legal side of the question, there have been found to be serious practical difficulties in the way of any thorough-going policy of moral suasion. The chief of these is that it is well-nigh impossible to trace the use to which a member bank puts the funds it acquires through rediscount. Most member banks do not themselves know. They generally borrow or rediscount at a reserve bank to make up deficiencies in their reserves incurred as the net result of all their operations, and it is seldom possible to discover the connection between such borrowings and the specific transactions which give rise to the necessity for borrowing. In many cases the only result of refusing credit would have been to put the reserves of the member banks below their legal limits. It will be seen later that the reports and examinations provided for in the act have not been a very helpful guide in this matter.

Although moral suasion has aimed mainly at eliminating speculative loans by member banks with reserve funds, it has had other ends. It has already been noted that during the War an attempt was made to divert credit into War industries. Another purpose has been the discouragement of continuous borrowing at federal reserve banks ; there is, as seen above, a tradition among the best banks that they should not be continuously in debt to the reserve banks, but frequently action has had to be taken. Other aims have been the prevention of the

flow of reserve bank credit to non-member banks, and the reservation of member bank credit for legitimate local requirements.

The methods of moral suasion have been of various orders of severity. There have been recommendations to officials of member banks; requests for co-operation; reminders that the resources of reserve banks are not unlimited; individual banks have been informed that they were in receipt of their due proportion of rediscounts; progressive rates have been employed in allowing the renewal of fifteen-day borrowings; additional collateral has been required; federal reserve banks have bluntly refused to rediscount and cases are reported in which they have attempted to dictate the lending policies of member banks. The use of discretion was viewed with favour for three or four years after the War; in 1920, for instance, in nearly every district, warnings of some sort were sent to member banks, especially to those acquiring bonds, lending reserve funds on the call market and financing speculative enterprises. After 1922 less attention appears to have been paid to it, but at the end of 1928 and during 1929 it was again applied. It is essential, however, to remember that there has been no uniform practice. Such policy has been in the hands of the different reserve banks, which have, in different districts and at various times, favoured it in varying degrees, but have seldom favoured it so much as the Board at Washington, which did not have to put it into operation.

Amendments in the Federal Reserve Act in 1933 and 1935 will probably have the effect of reducing the need for moral suasion, while giving the reserve authorities definite legal power to employ it. The 1933 act added the following to section 4: "Each Federal reserve bank shall keep itself informed of the general character and amount of the loans and investments of its member banks with a view to ascertaining whether undue use is being made of bank credit for the speculative carrying of or trading in securities, real estate or commodities, or for any other

purpose inconsistent with the maintenance of sound credit conditions ; and, in determining whether to grant or refuse advances, rediscounts or other credit accommodations, the Federal reserve bank shall give consideration to such information ". Any undue use of bank credit is to be reported to the Board with a recommendation, and the Board may terminate or suspend the use of reserve credit facilities by the bank in question.

Again, fifteen-day advances against eligible security are to be immediately due for repayment " if any member bank to which such advance has been made shall, during the life of such advance, and despite an official warning of the reserve bank of the district or the Board . . . increase its outstanding loans secured by collateral in the form of stocks, bonds, debentures, or other such obligations, or loans made to members of any organised stock exchange, investment house or dealer in securities, upon any obligation . . . for the purpose of purchasing and/or carrying . . . investment securities (except obligations of the United States ". The penalty is again suspension of reserve credit facilities.

On the other hand there are also restrictions on member bank dealings in securities (see p. 419) and on the total of loans by any member bank secured by stock or bond collateral (see p. 421). These should to some extent discourage member bank lending for speculative purposes, as should also the Securities Exchange Act, 1934, which aims at making speculation in general more difficult and less attractive.

Again, there is also in the act an express provision that no member bank shall rediscount paper with a federal reserve bank on behalf of a non-member bank, except with the permission of the Board.

It is, however, impossible to foretell what part moral suasion will play in banking policy, until member banks are again lending freely. The law is stricter than it was, but the legal experts of American banks usually find methods of achieving the banks' ends within the law.

THE RECONSTRUCTION FINANCE CORPORATION

The Reconstruction Finance Corporation (R.F.C.) was established by the R.F.C. Act in February, 1932, when the large numbers of bank failures (of which there were 700 in the previous two months alone) were rapidly forcing deflation on the country, businesses were going bankrupt, railroads and public utilities were contracting big debts and unable to pay interest on loans, and the country was on the way to economic collapse. It was a vicious circle in which the plight of industry and agriculture had frozen the assets of the banks, and the consequent failure of the banks was depriving the small man of his savings and business of credit, and driving still lower the low prices which had brought industry and above all agriculture to the verge of ruin. The broad aims of the R.F.C. were to raise commodity prices by pumping money into the economic system, and to put the banks in a stronger position by taking over their sound, but frozen, assets. As time went on and the New Deal came into existence, its functions greatly increased, and it became engaged in all sorts of measures of relief, recovery and reconstruction,—loans to insurance companies, railroads, building associations, public authorities, industry, agriculture (on live stock, grown crops and mortgages). It purchased cotton, wheat, gold, securities. Hundreds of millions of dollars worth of rural, urban and home mortgages were refinanced through its agency, and hundreds of millions distributed in relief. At the end of 1934 its balance sheet totalled \$4½ billions.

The R.F.C. is a public corporation with a capital of \$500 millions subscribed by the U.S. government, and with the power to issue government-guaranteed debentures up to about \$5 billions. It has 32 branch offices in different parts of the country, and central management is vested in a board of 7 directors, of whom one is the Secretary of the Treasury and the other 6 are appointed by the President with the approval of the Senate. The

R.F.C. works in close co-operation with the reserve banks, and with the Federal Deposit Insurance Corporation, which is described later.

We are concerned only with certain aspects of the relations of the R.F.C. with the commercial banks, and here the distinction between member and non-member banks does not arise, for the R.F.C. exists to come to the aid of any bank. The R.F.C. has helped the banks in three main ways :—

(1) by making loans to active banks, to put them in a liquid position ;
(2) by making advances to closed banks, to enable them either to reorganise or to pay out depositors with the minimum of delay ;
(3) by purchasing the preferred stock, capital notes and debentures of banks whose capital structure is weak.

In this connection it was particularly useful in aiding banks to qualify for the privilege of deposit insurance. Up to August, 1935, \$1893 millions had been distributed under the first two heads and \$1451 millions repaid; \$1016 millions had been expended and \$114 millions repaid under the third head. The numbers of loans and purchases were respectively 2500 and 8300. In December, 1936, the R.F.C. still owned stock, capital notes and debentures in 5298 banks to the value of \$643 millions. The total issues of stock of these banks amounted to \$3,081 millions. It may be added that of the banks in question 1785 were national, 330 state member and 3183 state non-member banks, the stock-holdings of the R.F.C. being respectively \$314 millions, \$136 millions and \$192 millions odd. All these banks were insured with the F.D.I.C. The R.F.C. held stock to the value of about \$20 millions in a few uninsured banks.

Loans have only been made against security which, though not immediately realisable, is " sound "—i.e. capable of liquidation over a period of years. The

contract under which loans have been granted has contained among other things a proviso for "inspections and audits of any books, records and papers in the custody or control of the applicant or others, relating to its financial or business condition . . . and the inspection and valuation of any of its assets, at the applicant's expense, and in such manner as the corporation may require. Constituted authorities [1] are authorised to furnish reports of examinations, records and other information relating to the condition of the applicant." The R.F.C. is required by law to obtain an agreement from any bank to which a secured loan is made that the salaries of officers, directors and employees shall not be increased to any amount in excess of what appears reasonable to the corporation. It is at liberty at any time to call for additional collateral to its loans, if it thinks fit.

It is, however, rather in purchasing the preferred stock of banks that the R.F.C. has acquired real control. A preliminary has always been the filing by the applicant of the complete details of its condition, a schedule of assets and a statement of its proposed reorganisation plan, if any reorganisation is intended. Banks have further to show that their earning capacity will be sufficient to pay dividends of 4 per cent. (formerly 6 per cent.) on preferred stock, after full provision has been made for bad debts and contributions to surplus and reserves.

The issue of preferred stock involves changes in a bank's charter and the R.F.C. prescribes standard forms of charter, which vary only slightly for the various classes of banks. The prescribed charter gives the holders of both preferred and common stock one vote for each share of stock held by them. The par value per share and number of shares of preferred and common stock is required to be fixed so that the number of votes to which the holders of preferred stock, as a class, shall be entitled shall bear approximately the same ratio to the

[1] For example, other federal examining authorities, such as the Comptroller of the Currency.

number of votes to which the holders of common stock, as a class, are entitled as the amount of the preferred stock investment bears to the sound value of the common stock. As the main holder of preferred stock the R.F.C. has thus substantial voting rights. In addition to this, the standard form of charter provides that in the event of default the holders of preferred stock shall be entitled, as a class, to twice the number of votes to which the holders of common stock, as a class, are entitled; and that, while the votes of preferred stockholders are so increased, any of the directors, officers or employees of the bank may be removed and their successors elected by the casting of two-thirds of the votes to which the holders of all classes of stock, voting as one class, are entitled. It also provides that in the event of the existence of certain specified conditions (e.g., the value of assets sinking below liabilities, or dividend payments on preferred stock being in arrears), all directors, officers and employees of the bank shall receive compensation at rates not exceeding such maximum limitations as may be fixed by the vote of the holders of the majority of the outstanding preferred stock. The special consent of the holders of preferred stock is also required for the extension of premises and the making of loans maturing more than a year from the date of their creation. In addition to the rights conferred on it by a bank's charter as the holder of preferred stock, the R.F.C. has in many instances required the bank to furnish an agreement with respect to the salaries of its officers, directors and employees similar to that required in connection with secured loans, and also an agreement that its management will at all times be satisfactory to the corporation.

While the R.F.C. has thus acquired voting control in a large number of banks, its general policy in the election of directors has been to vote its preferred stock in favour of those chosen by the common stockholders, except in a few instances where a change of management has been deemed necessary for the protection of its investment or

of the depositors. It has, however, required that all increases in salaries and changes in officer personnel be submitted to it for approval in those cases in which it has an agreement with respect to salaries and management. In many cases the R.F.C. has set a limit to the amount that may be paid by way of dividend on the common stock of banks whose preferred stock it holds. It also usually requires that a substantial part of net profits be set aside for the retirement of preferred stock.

Most of the big banks, which did not really need additional capital, but were persuaded by the government to obtain it from the R.F.C. in order not to show up the weaker banks, issued not stock, but capital notes, —usually short-dated. Other banks, which are not legally permitted to issue preferred stock exempt from double liability, have also issued capital notes and debentures. These do not confer voting rights, but the R.F.C. has usually stipulated for a limitation of salaries, has demanded the right to examine each bank at least once a year, and has reserved itself the power to remove officers and directors in certain contingencies.

In November, 1934, the chairman of the R.F.C. made the following statement on R.F.C. policy: "The ownership of this stock by the government carries with it great responsibility, and must be administered with care and consideration for local interests. Prospective borrowers must not expect Washington to influence the bank management in making loans. We have been asked repeatedly for bank managers or bank presidents, but have only supplied one bank officer. We want nothing to do with bank management, but as any other prudent stockholder, will vote our stock for the most capable, honest management that is available. While there is no disposition to dictate bank management, we have in some instances insisted that the management be strengthened, leaving the directors free, however, to select new officers, sometimes with our approval." This is also the policy which the R.F.C. appears to have followed since that

date, only intervening when an extraordinary situation demanded it. In spite of this, however, it is clear that the R.F.C. exercises over the 5000-odd banks whose stock it holds a control in many ways more intimate than that of the reserve banks over their member banks. Unlike the reserve banks and the F.D.I.C., the R.F.C. is not a permanent institution, and, as its officials have frequently asserted, it wishes to "get out of the banking business" as soon as possible. What will probably happen is that when there is a better market for bank stock the R.F.C. will either, with the permission of the banks, sell its holdings of preferred stock in the market, or call for their redemption out of the proceeds of new issues of common stock. This process of "retiring the preferred" is, in fact, already taking place, for the bank stock investments of the R.F.C. declined during 1936 by $225 millions, reducing its outstanding holdings to about three-quarters of their peak level. It is apparent, however, that for some years the R.F.C. will be an important element in commercial-bank control.

The Federal Deposit Insurance Corporation

The Federal Deposit Insurance Corporation (F.D.I.C.) was established by the Banking Act of 1933, to insure the deposits of commercial banks against failure. Several important changes were introduced by the Banking Act of 1935, but the underlying principles were retained. The whole of the legislation affecting federal deposit insurance is to be found in section 12B of the Federal Reserve Act as amended, but the F.D.I.C. issues regulations from time to time, by way of interpretation of the law. The F.D.I.C. is a public corporation with a capital of nearly $300 millions, of which $150 millions are contributed by the Treasury and the remainder by the federal reserve banks, and is governed by a board of three directors (one of whom is the Comptroller of the Currency).

In return for having the deposits of each of their customers insured up to $5000, banks included in the scheme pay an annual premium of 1/12 per cent. of their total deposits. Federal reserve member banks are compelled to insure, the penalty of termination being in the case of national banks liquidation, and of state member banks expulsion from reserve membership. State non-member banks are permitted to insure, but after December, 1941, no state banks with deposits of $1 million or more may insure unless they are members of the federal reserve system. One of the more material effects of deposit insurance is therefore likely to be an extension among state banks of federal reserve membership. As the insurance of their deposits is keenly appreciated by members of the public, the vast majority of banks in the country has found it necessary to participate in the scheme, and there seems little doubt at present that when in 1941 a number of state banks will have to choose between continuing deposit insurance as federal reserve members and terminating insurance in order to avoid reserve membership, they will choose the former. The government will thus virtually compel the vast majority of commercial banks to take up reserve membership, though unfortunately the very small banks will still be able to stand out. The results that may be looked for are a strengthening of credit control and a general extension of high banking standards. Similarly, as all member banks must insure, any restraints which insurance regulations impose will also be practically universal. The effect of the F.D.I.C. on the standard of banking, however, does not stop here, and we have now to consider briefly its other aspects.

Admission

On application for admission to insurance, national and state member banks have to be certified to be solvent by the Comptroller and the Reserve Board respectively; state non-member banks are examined by the F.D.I.C. Admission is only granted after consideration of the

following factors: the financial history and condition of the applicant bank, the adequacy of its capital structure, its future earning prospects, the general character of its management, the convenience and needs of the community to be served by it, and whether or not its corporate powers are consistent with the purposes of section 12B of the Federal Reserve Act. If wisely and strictly employed, this will prove a strong instrument in the hands of the authorities, and should prevent overbanking. One of the great problems of American banking has been the growth in times of prosperity of numerous mushroom banks for which there was no real demand. Such banks are hardly likely to be admitted to insurance, and without this privilege will be unable to set up in competition with insured banks. As far as capital structure is concerned, the F.D.I.C. has used as a rule of thumb a minimum ratio of capital to deposits of one to ten. Undercapitalised banks are enabled to qualify through the R.F.C.

Termination of insurance

Whenever the board of directors of the F.D.I.C. finds that an insured bank or its directors or trustees have continued unsafe or unsound practices, or have knowingly or negligently permitted any of its officers or agents to violate any provision of the law or regulation to which the insured bank is subject, it must report the matter to the competent authority,—the Comptroller, the Reserve Board, or the state banking authorities (in the case of non-member banks). If no correction is made within 120 days (or shorter if the competent authority requires it), the board is to summon the bank to state its case, and, if it cannot make out a good case, to terminate its insurance (and thus its reserve membership, if it is a member bank). The efforts of the F.D.I.C. in this direction have in practice been limited to state non-member banks. In the majority of cases moral suasion has been found to be sufficient.

Examinations and reports

The F.D.I.C. has the power to examine any insured bank whenever in its judgment an examination is necessary, but the permission of the Comptroller and the Board of Governors is required in the appropriate cases. In practice the F.D.I.C. examines only non-member state banks, but each non-member state bank is examined once a year at least and the number of such banks is over 7000. Such examinations are usually made in co-operation with the state authorities.

The F.D.I.C. has access to the reports of examinations made by, and of reports made to, state banking authorities. It is specifically authorised to demand reports of condition from insured non-member state banks, when and in whatever form it wishes. It may require these reports to be published.

Capital

No insured state non-member bank may reduce or retire any part of its common or preferred capital stock, or capital notes and debentures, except with the consent of the board. National banks, of course, require the consent of the Comptroller, but there is no such federal restriction on state member banks.

Branches

Insured state non-member banks may not open new branches, except with the prior written consent of the F.D.I.C. Nor may branches be moved from one place to another without consent. In granting consent the board takes account of the factors which are considered in admitting new banks to insurance.

Mergers

In addition to compliance with other provisions of law, the prior written consent of the board is necessary before any insured bank may enter into any consolidation or

merger with an uninsured bank, or assume in any way a liability to pay deposits with an uninsured bank.

Miscellaneous

Every insured bank has to display at each place of business a sign in a form and manner prescribed by the F.D.I.C., to the effect that its deposits are insured.

The F.D.I.C. may require insured banks to insure against burglary, defalcation and other similar insurable losses. This provision was added in 1935 and, in view of the comparatively frequent defalcations in some parts, is a useful protection.

No insured bank may pay any dividend on its capital stock or interest on its capital notes or debentures, while it remains in default in the payment of insurance premiums due. The F.D.I.C. has power to limit the interest paid on deposits in insured banks, and it has applied to non-member state banks the provisions contained in the federal reserve regulation already referred to.

Publication of reports, etc.

When any insured bank other than a national bank, after written notice of the recommendations of the F.D.I.C. based on a report of examination, fails to comply with such recommendations within 120 days, the F.D.I.C. may give the bank ninety days' notice of its intention to publish the part of the report including the recommendations, and in due course publish it.

Considered in a detached way, the provisions for control by the F.D.I.C. appear a rather curious combination of restraints and requirements. Reference to the National Bank Act and Federal Reserve Act shows, however, that what they attempt to do is to extend to as many state non-member banks as possible some of the more important requirements now made of national and state member banks, and to force as many banks as possible into the reserve system. Apart from this, it is clearly an advance

to have a federal authority virtually controlling the number of banks in operation in the United States. The one criticism that might be made is that it may not be desirable that an authority which is so financially interested in keeping banks open should share responsibility for supervision. It is doubtful, for instance, how far the F.D.I.C. could be expected to publish adverse reports on insured banks in bad condition. This might result in runs and failures. Efficiency also demands that there should be only one federal supervisory authority.

As far as its present record goes, however, the F.D.I.C. seems determined to do its work thoroughly and to use all its supervisory powers to the full.

The policy of the F.D.I.C.

The attitude of the board of the F.D.I.C. to the duties which have been entrusted to it may be gathered from one or two quotations from its latest report, published on 8th February, 1937 :—

" The decrease in the number of insured banks (in 1936) resulted in part from a definite program of eliminating insolvent or weak banks, either by closing them or merging them with sound banks with aid from the Corporation, in part from mergers and consolidations, and in part from the exercise of control by supervisory authorities over the chartering of new banks."

" The Corporation favors the establishment of banking facilities in every community which can furnish sufficient justification for banking service, but it opposes the chartering of institutions which it believes to be economically unsound and likely to fail. It has received the co-operation of most of the supervisory authorities in preventing the indiscriminate chartering of banks. However, there will be an increasing pressure for the creation of new banks, as the banking business becomes more profitable and more attractive to investors. Unless effective and proper control of chartering is maintained our banking system will inevitably be weakened."

"The Corporation is insisting that banks under its supervision take their losses when they occur, in order that their true condition may be reflected. It is insisting that banks maintain adequate capital structures and that banks which seek to retire their preferred capital shall retain capital sufficient to provide protection against the uncertainties of banking operations. It is taking action against banks which continue to engage in unsafe and unsound practices."

It would therefore appear that the F.D.I.C. is taking its duties seriously and doing really constructive work. If it succeeds in the future only in preventing overbanking, it will perform an invaluable service for the country.

Clearing-House Associations

Designed primarily to effect the clearing of cheques, American clearing houses have come to play quite an important part in the regulation of banking in their areas, by compelling their members to observe their rules and regulations. These cannot be dealt with at length, but merit a short consideration.

The New York Clearing-House Association consists of some twenty members, five of which are national banks and the remainder state banks. New banks are admitted on the affirmative vote of a majority of the members, voting by ballot, but no new bank may be admitted unless it has a capital of at least $1 million. Admission fees also become payable—$5000 in the case of banks with a capital of under $5 millions, $7500 in the case of other banks. Any member bank may be expelled on the vote of a majority of the members, and if a member bank changes its management, ownership or charter, or merges with a bank not a member of the Association, its membership is reviewed. Cash reserve requirements are those of the federal reserve system and State of New York for reserve member and non-member banks respectively, but a few further restrictions are imposed by a special

definition of " deposits ". Banks which are not members of the reserve system must keep their reserves other than cash with the New York federal reserve bank, with a member of the Association which is also a member bank of the New York reserve bank or with a bank which keeps with that reserve bank the statutory reserve required of federal reserve member banks. Every member of the Association is required to furnish a weekly report of its average daily condition and of its actual condition at the close of business each Friday, on a form prescribed by the Association.

The Association is governed by a committee of five members, annually elected, who are authorised to prescribe rules and regulations, subject to the Association's approval. It prescribes in particular the rules under which the Association's examination department is maintained; and may cause any member to be examined, when it deems it in the Association's interest, and may require any member to deposit security to protect its clearing balances.

There are also provisions for clearing the cheques of banks not members of the Association, but here, again, a fee of $1500 is payable and such banks must keep the same reserves, submit to the same examinations and make the same weekly reports as members of the Association.

There are, naturally, a number of technical rules concerning the clearing itself, which need not be examined. The constitution of the Association also specifies maximum rates of interest payable by its members on customers' credit balances of various sizes, and collectable on certain types of loan. Uniform charges are imposed on the banks which clear through the Association.

As the clearing associations control the enjoyment of clearing facilities both by members and by banks clearing through them, they are in a strong position to enforce a high standard of banking. It is usually in their interests, too, to help members in difficulties, and this is useful in fostering public confidence in the banks. Charges have

been made against the associations ; in particular, that they have developed into ruthless money trusts. It appears, however, that they have generally used their powers with restraint and often exercise a beneficial influence on banking stability. For instance, members of the New York Clearing-House Association agreed as early as 1930 not to act as a channel for loans to the call market from outside sources, thus anticipating federal law by three years. The mortality of banks which are members of the bigger clearing houses is certainly very low. It is concluded, therefore, that clearing-house associations serve a useful purpose in the banking structure of the country, apart from the facilities which they offer for the cheap and efficient clearance of cheques.

Reports and Examinations

In addition to any examinations which the banks impose on themselves or which the clearing houses of which they are voluntary members impose on them, they are also subject, as has been seen, to government examinations. State banking authorities examine state banks; the Comptroller of the Currency examines national banks ; the Board of Governors of the federal reserve system is empowered to conduct regular examinations of member banks, though it has, in fact, had to be content with those of the Comptroller for national banks and generally with those of state authorities in the case of state banks ; the federal reserve banks are authorised to examine member banks in their districts with a view to ascertaining the lines of credit extended by them ; the R.F.C. has certain rights of examination ; and lastly the F.D.I.C. has the power to examine banks participating in the deposit insurance scheme. All these authorities are also entitled to reports of condition at more or less regular intervals.

One of the aims of the Federal Reserve Act, according to its preamble, is " to establish a more effective

supervision of banking in the United States ", and this has clearly been the aim of all the acts which have introduced systems of examinations and reports. Yet between January, 1921, and December, 1933, there were about 16,000 bank failures in the United States. These failures have been due to a wide variety of causes. Among the most prominent are " lack of co-operation on the part of the public " (i.e. runs on banks) ; bad management ; dishonesty and peculation ; speculative investments ; risky operations in real estate ; loans on poor security (e.g. second or third mortgages) or none at all ; unwise lending to employees and generally the possession of a high proportion of " questionable assets ". Examinations could not have eliminated the first of these (though the knowledge that strict examinations were being conducted might have done), but they should have prevented the others. Statistics show that although bank failures appear superficially as sudden disasters, in fact there is in the majority of cases a gradual deterioration of bank assets over a period of years.[1] It would seem that either the increasing weakness of banks has not been detected, or else examiners have failed to criticise it, or have been unable to bring about correction. All three factors have in fact been partially responsible.

In the first place, a witness before a Senate committee in 1933 stated that false entries and misrepresentations of banking conditions were by no means uncommon in the books of banks. This provides examiners with some measure of excuse. Another practice which made examination difficult prior to 1933 was that of transferring bad assets from one affiliate to another just before examination : this has now been made practically impossible. It has also been urged that criticism of a bank's investments is exceedingly difficult, and that examiners have not the experience or ability to value securities. It must be remembered, too, that the cost of examinations is borne normally by the banks examined

[1] See C. D. Bremer, *American Bank Failures*, p. 102.

and that examiners have probably not felt justified in running up heavy expenses for them. It would have been better if examiners had been altogether independent of the banks.

Failure to criticise has also played a part. Political favouritism and interference do not appear to have been absent. The federal reserve banks, which rely principally on the Comptroller and state authorities, have also complained that the Comptroller has frequently been slow to furnish them with information and has only handed on to them his published reports (which do not necessarily reveal his private view of the state of national banks), while state authorities have not always conducted thorough examinations. Reserve banks have themselves made many examinations at their own cost or have sent one of their own force to be present at the examinations of other authorities, but their own competence only extends to " condition and lines of credit ", and the Board has discouraged their prying into bank policies and investments, maintaining that their main guide in extending credit should be a statement from the Comptroller or from a state banking department that a bank was in a safe position. And it must be confessed that there has been some slowness on the part of some reserve banks to do anything that might impair their good relations with their member banks or to look too closely into the condition of member banks which were heavily in their debt. The reserve banks are, however, constantly in touch with member banks through the officers of their Member Bank Relations' Departments and have been able to acquire information through the personal visits of these officers.

Thirdly, there have been many instances of authorities being in possession of information, but unable to bring about correction. Comptroller Pole stated before a Senate committee in 1930 that there had been little beyond moral suasion with which to combat objectionable practices, except in the case of direct violations of the law. The Comptroller has, as a matter of fact, the power to

summon the boards of directors of national banks, and this he has frequently done, but on such occasions he has often not been able to exact more than promises. Another deterrent employed has been to put bad banks on the list for frequent examination. In some cases national banks have failed within two months of examiners reporting them to be in a solvent position. The difficulty is that it is in practice impossible to make a very adverse report on a bank, for the reports on national banks are by law published in local newspapers, and a bad report would immediately cause a run. Most of the shortcomings of the banks have not been violations of the letter of the law, but of its spirit. At a Senate committee meeting in 1931 Senator Glass recounted that he once asked a banker if he ever violated the statutes. "Why, yes," he replied. "What do we hire the best legal talent in the world for, except to evade the law?"

Direct violations of law are punishable, but fines have not been found to be effective, and the only other penalty available until 1933 was too drastic for what was often a technical violation of a minor provision of the law,—suspension in the case of national banks, expulsion from the system in the case of state member banks. The reserve banks are now, however, empowered, with the help of the Board, to remove directors and officers, and this should prove a useful and adequate weapon.

It is not, however, to be imagined that examinations have been useless. The mere existence of examinations and reports must have imposed restraints. Also, much sound advice has been given by examiners and the authorities. The Comptroller of the Currency stated in 1930 that in the previous five years he estimated that he had saved 500 banks from failure.

How do the banks themselves regard reports and examinations? It has already been noticed that the cost of examinations is generally borne by them. The reports which they have had to furnish have also been a big item of expenditure. An article in the *American*

Bankers' Association Journal for March, 1936, gives an account of the reports submitted by a typical trust company member of the reserve system. Reports are made for about 50 different purposes and number about 700 during the year. A staff of 15 is permanently employed in providing the information, and the annual cost is approximately \$150,000. About a half of this, it is true, is spent on supplying information to the various taxing authorities, but an inspection of a national bank report of condition to the Comptroller shows what an immense amount of work must be involved. On one dated 1934, lying before the writer, assets are to be analysed under 14 heads, liabilities under 25. Customers' securities pledged against loans are set out under 13 heads, contingent liabilities under 4. Certain balance-sheet items are then taken and subjected to further analysis, loans and discounts being divided into 14 classifications, government securities into 10, other bonds, stock and securities into 16, bills payable and rediscounts into 8, cash and balances with other banks into 14, sundry liabilities into 5, and deposits into 14. Certain " itemized statements " are required of other assets, other liabilities, branches, the names, stockholdings, liabilities, overdrafts, deposits, etc., of officers and directors. This one report has to be completed at least three times a year. It thus becomes apparent that the lavish publications of statistics provided annually and even month by month by the banking authorities are produced largely at the banks' own expense. And it must be remembered that the majority of American banks are not institutions like the English " Big Five ", but small unit banks upon which the furnishing of such reports constitutes a severe strain.

Clearly, if all the examinations and reports authorised by law were made, there would be much multiplication of activities. And even though in many cases one authority will accept a report made to another and an examination made by another, there is still overlapping. For this reason a committee was appointed in May, 1935,

to make recommendations for a standardisation of reports. It included representatives of the American Bankers' Association, the Comptroller, the F.D.I.C., the Board of Governors of the federal reserve system, the R.F.C., the Treasury, the state bank commissioners and other authorities and associations. The view was taken by the committee that the standard report should serve primarily two purposes,—it should inform the public, and provide the basis for studies on a national scale. The standardisation of reports would have led in time to the standardisation of book-keeping methods, which vary greatly over the country ; this would in turn have facilitated examinations. It was hoped also in time to evolve a standard system of examination. Unfortunately, however, it was found impossible to reach any agreement and the deliberations of the committee have been suspended for the time being. The task of standardisation, however, is one which urgently requires to be undertaken.

Conclusion

From January, 1921, to December, 1933,[1] inclusive 16,006 banks suspended payment in the United States, and this alone is an argument for reform and control. It is instructive, at risk of repetition, to catalogue the causes of failure. They include inexperience ; mismanagement ; defalcations ; overbanking ; the general instability of business and economic conditions ; the depressed state of agriculture since the post-War boom ; the shift of population from small towns to large cities (rendering country banking less profitable) ; an increasing investment of bank funds in the less liquid types of paper ; unsecured loans to officers and directors ; failures of big debtors and of correspondent bankers ; inefficient examinations ; laxity in making loans, especially on real estate ; laxity in calling in loans ; competition, leading to risky transactions in

[1] Apart from temporary closing during the bank holiday of March, 1933.

order to cover interest payments ; ostentation in premises ; the practices of carrying questionable securities and over-investing in fixed assets ; the spread of chain stores, which finance themselves in the big centres ; the extension of hire purchase ; the failure of the public to co-operate (panic-stricken withdrawals) ; and the increase in the size of the business unit in general, which adversely affects the small unit bank. Many of these shortcomings, as has been seen, have received the attention of the legislators, and in some cases former provisions of the law have been considerably strengthened. There seem, however, to be two factors in American banking which not only lie behind very many of the weaknesses enumerated in this paragraph, but are still fundamental obstacles to the real safety of the banking system of the United States.

Reference was made in the first few pages of this chapter to the fact that there exist in the United States not one but forty-nine banking systems. This fact is inherent in the constitution of the country, and the multiplicity of jurisdictions in banking is but a special instance of a general feature of American economic life. Natural forces have for decades been leading to a nation-wide extension of business and trade, of markets, transport, insurance and banking. It has become increasingly desirable that there should be national standards of, for example, labour conditions, tariffs of charges for economic services, taxation and public utilities. Progress has been made, yet federal control in these and other matters remains incomplete. The federal government has no direct power to compel state-chartered institutions to conform to a national code of practices.

Mention has also been made of the particular drawbacks of a dual system of chartering banks, and of how it led to a weakening of the regulations governing national banks in such matters as minimum capital requirements (1900). In 1906 the restriction on loans to one customer by national banks was relaxed ; in 1913 national banks were first permitted to make loans on real estate under

conditions which were considerably modified by acts in 1916 and 1927; the Federal Reserve Act also permitted national banks to transact trust business under restrictions which were very much liberalised in 1918, 1922 and 1927. There have been a number of such steps, both before and since the passing of the Federal Reserve Act, and even in 1929 a speaker at the American Bankers' Convention stated that "to maintain the national banking system at its present high standard it will be necessary to enact legislation granting national banks privileges which would make a national charter so attractive, that not only would desertions from the ranks cease, but new recruits be added from every side".[1] It seems also as if the fear of causing dissatisfaction among national banks has been a deterrent to the full use by examiners of their powers of control. Consequently management has suffered.

The weaknesses of a dual system, however, do not stop here. The movement towards a greater concentration in banking in the United States, whether it has taken the form of group or chain banking or of amalgamation, has emphasised the serious consequences of the system. Concentration is largely a result of natural economic forces,—the increase in the size of business units, the recognition of the advantages of spreading risks and the appreciation of the economies of large-scale operation. Concentration, however, has led to abuses which it has proved difficult to prevent or regulate. There have been cases of banks being bought for re-sale at a profit at a later date; sometimes the device of a holding company has been used to cloak speculation, financial malpractices and the shifting of questionable assets at times of audit; sometimes banks have been merged to provide the funds to acquire a controlling interest in a manufacturing business or to support the market value of that business's securities. The scope for such practices is almost limitless.

The difficulties of control have proved to lie in the

[1] See C. D. Bremer, *American Bank Failures*, p. 95.

fact that the components of a group or chain have frequently been subject to a number of jurisdictions, for example, those of the Comptroller of the Currency, three or four federal reserve districts and half a dozen states. Holding companies, when they are formed for ulterior purposes, are naturally chartered in states with lax supervisory provisions. It has proved impracticable to arrange for reports and examinations to coincide, and consolidated statements of account have frequently not been available. It has not been within the powers of the federal authorities to prevent group banking, and it would be impossible to persuade all states to legislate against it at once or, as would be more desirable, to enforce uniform regulations. The Banking Act of 1933 has achieved something, so far as federal reserve member banks are concerned: loans to affiliates are regulated, reports and examinations have been extended to holding companies, the voting rights of holding companies have been restricted, and consolidated statements of condition are required. Holding companies must build up reserves of readily marketable securities and security affiliates have been disaffiliated. Such provisions, however, only affect member banks, and thus do no more than begin to face the problem, while having the unfortunate but inevitable effect of making the possession of a national charter or membership of the reserve system even less popular.

Dual control has other disadvantages. It leads to the duplication of examinations, the costs of which are severe. It raises difficulties with regard to the double taxation of banks. It renders impossible a national policy in connection with branch banking and other important matters; there is no unified credit policy, as far as non-members of the reserve system are concerned; and the attempt to introduce a nation-wide system of par remittance has failed dismally. The only way in which the federal authorities can obtain control is by adding to the attractions (in the form of the right of rediscount, the insurance

of bank deposits and so on) of membership of the reserve system. Even were this successful, however (and experience with trying to popularise the possession of a national charter provides little basis for optimism), there is still a division of authority at the apex of the pyramid, supervision and responsibility being divided between the Board of Governors, the reserve banks, the Comptroller of the Currency, the F.D.I.C., the R.F.C., the Open Market Committee and the Treasury. These organs are closely in touch with each other, but there is no complete co-ordination.

The second fundamental obstacle to a safe banking system is the preservation of unit banking. The problem is partly the same as that of the multiplicity of jurisdictions, in that the latter restricts interstate branch banking. But about a third of the states prohibit even intra-state branch banking, and a further quarter of them only permit it within very restricted limits ; thus unit banking in turn intensifies the difficulties inherent in the multiplicity of jurisdictions, for in the absence of branch banking the only means of operating on a large scale is by membership of a group or chain. This, we have already seen, immediately raises problems which do not arise in a branch banking system, where all the branches of a bank are under the same jurisdiction.

The argument put forward in favour of unit banking is that the unit banker is best able to serve the interests of his local community, and that local ownership of a bank identifies the interests of the bank with those of the community in which it is situated. But experience elsewhere refutes the first part of this argument, and the concentration in a few hands of the stock of the average local bank, the second. The chief forces in favour of the continuance of unit banking are the frequently referred to national fear of a " money trust " and, probably more important, the desire for independence, from personal motives, on the part of unit bankers themselves. Many of the weaknesses of American banking arise from the

unit system,—mismanagement, overlending to officers and directors or to a single customer, the freezing of loans, overbanking, weakness in face of the failure of a local crop, inadequate inspection, inadequate banking talent, insufficient outlet for funds, the diseconomy of big reserves, competitive interest rates, frequent "runs", ostentatious premises, subjection to local political influence, lack of uniformity in accounting methods, expensive examinations and even an excessive degree of legal restriction which, as English experience shows, can be dispensed with in a highly concentrated system.

It appears, therefore, that through its inability or unwillingness to surmount the two obstacles referred to in this concluding section, the American nation has projected before itself a host of minor difficulties. These it may succeed in overcoming,[1]—how far it will succeed cannot be known until the country is again presented with a grave crisis,—but it does not appear to be following the most straight-forward and most logical route to a sound banking system. Even when this is achieved, there remains the problem of unified credit control,—a problem which the country has still to work out for itself.

[1] There are two hopeful portents :—first, that the number of banks has not materially increased in the last three years ; and second, that in the three years 1934–36 only six national banks and no state member banks failed. But it must be remembered that these have been years that will go down in the annals of banking as of unparalleled over-liquidity.

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